



THE
CONFERENCE
PROCEEDINGS

November 14, 2001

KENTUCKY
LONG-TERM POLICY RESEARCH CENTER



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Edited and Compiled by
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The Kentucky Long-Term Policy Research Center is governed by a 21-member board of directors, including four appointees from the executive branch, six from the legislative branch, and eleven at-large members representing organizations, universities, local governments, and the private sector. From the at-large component of the board, six members are appointed by the Governor and five by the Legislative Research Commission. In accordance with its authorizing legislation, the Center is attached to the legislative branch of Kentucky state government.

PREFACE

As part of its mission to advise and inform the Governor, the General Assembly, and the public about the implications of trends influencing the state's future, the Kentucky Long-Term Policy Research Center presents the proceedings from its eighth annual conference, held in Frankfort, KY, on November 14, 2001. The daylong conference highlighted distinguished speakers on Financing State and Local Government, and featured a panel discussion taped by Kentucky Educational Television. The conference provided significant food for thought for policymakers and citizens of the Commonwealth who are interested in and concerned about the future of our state.

KENTUCKY LONG-TERM POLICY RESEARCH CENTER

The Kentucky Long-Term Policy Research Center was created by the General Assembly in 1992 to bring a broader context to the decisionmaking process. The Center's mission is to illuminate the long-range implications of current policies, emerging issues, and trends influencing the Commonwealth's future. The Center has a responsibility to identify and study issues of long-term significance to the Commonwealth and to serve as a mechanism for coordinating resources and groups to focus on long-range planning.

Michael T. Childress serves as the executive director of the Kentucky Long-Term Policy Research Center. Those interested in further information about the Center should contact his office directly at:

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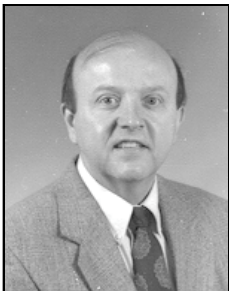
Walter A. Baker is an attorney in Glasgow, Kentucky. He graduated from Harvard College (A.B., *magna cum laude* and Phi Beta Kappa) and from Harvard Law School (LL.B.). He served as a state representative of Kentucky's 23rd House District from 1968 to 1971 and as a state senator from the 9th Senatorial District from 1972 to 1981 and from 1989 to 1996. He was the Assistant General Counsel for International Affairs, Office of Secretary of Defense in the Department of Defense, from 1981 to 1983 and a Justice in the Kentucky Supreme Court in 1996. Mr. Baker served as Judge Advocate with the rank of Lt. Colonel for the USAFR, Kentucky Air National Guard, from 1961 to 1981. He received the Kentucky Council on Crime and Delinquency Outstanding Service Award (1975), Department of Defense Outstanding Public Service Award (1983), the Louisville-Jefferson

County Crime Commission Legislator of the Year Award (1990 and 1992), the Barren River ADD William H. Natcher Award for Outstanding Public Service (1995), and the Glasgow-Barren County Chamber of Commerce "Ernie Award" (1996). He is a Life Member of the Sixth Circuit Judicial Conference, serves on the Council for Postsecondary Education, and is First Vice President of the Kentucky Historical Society.



Evelyn Boone is a native of Covington and graduate of Bethel Women's College, Hopkinsville. She has been a resident of Elkton, Todd County, Kentucky, for 43 years. Ms. Boone originally owned the local county newspaper, *The Todd County Standard*. She has served in nearly every volunteer capacity through the years, as well as on the Elkton City Council and as Mayor for eight years (1982-1990). Presently, Ms. Boone serves on the regional Sanctuary Board (for abused women and children) and chairs the local group. She also chairs the Welform committee for Todd County and serves as a member of the Todd County School Board and on the Diversity, Strategic Planning, and Alternate Calendar committees. Ms. Boone also serves as a Sunday School teacher and member of the

Administrative Board of Petrie Memorial United Methodist Church, Elkton. She serves on the state Selective Service Board as Todd County representative and has recently been appointed to the Kentucky African-American Heritage Commission. Ms. Boone is widowed and has one daughter, deceased, and three grandsons, one 13 and twins 11, who live in Louisiana.



Jack Brammer has been the Frankfort bureau reporter for the *Lexington Herald-Leader* since 1983, primarily covering state government and politics. He has received recognition for his outstanding work in journalism from the Kentucky Press Association and Sigma Delta Chi and was a 1990 finalist for the Pulitzer Prize for investigative reporting. The former President of the Bluegrass Chapter of the Society of Professional Journalists has a hefty list of community affiliations that include President of the Shelby County Historical Society, former President of the Shelby County High School Parents-Teachers-Students Association, and Christian lay speaker and member of Southeast Christian Church in Louisville.



Robert W. Cox serves with the Governor's Office for Policy Research (GOPR). He is principally responsible for the official General Fund and Road Fund revenue estimates used to prepare the Commonwealth's biennial budgets. Mr. Cox received his master's degree in economics at the University of Virginia in 1985. After working as a research economist at the University of Virginia's Center for Public Service and Tayloe Murphy Institute for five years, he began working within the Kentucky Finance and Administration Cabinet in 1990. His primary interests are in the areas of public finance, regional economics, and input-output analysis.



Karen Cunningham is only the second female Mayor of the City of Madisonville and the youngest person elected to the office. Although only 38 when elected, Karen has a long record of public service, including service as President of the Boards of Directors of United Way of Hopkins County, James Madison Days, Madisonville Business and Professional Women's Club, Leadership Greater Madisonville, and the Waddill PTA. She has also served as Vice Chair of the Madisonville-Hopkins County Chamber of Commerce and as a board member of Discover Downtown and Big Brothers/Big Sisters. She is a past evaluator for the Kentucky Certified Cities Program and has served as a representative on the Green River Tourism Committee. She has served on the Kentucky Council on Community Leadership and was a charter member of the Leadership Greater Madisonville Class of 1985. Karen was chosen Woman of Achievement by the Madisonville Business and Professional Women's Club in both 1988 and 1999 and was honored as 1983 Madisonville Business and Professional Women's Careerist of the Year, as Realtor of the Year in 1989, as Volunteer of the Year in 1990, and as the Lions Club's 1991 Woman of the Year. She also received the 1987 Kentucky Business and Professional Women's Club Program Award. Karen holds a B.A. in Organizational Communication and Business Administration from Murray State University. A 1989 graduate of Leadership Kentucky, Karen accepted the position of Deputy Director with Leadership Kentucky in 1994. In 1999, Karen was selected from a field of over 300 applicants as a Kentucky Leader for the 21st Century and participated in that capacity in the Shakertown Roundtable. Governor Jones appointed her to the Madisonville City Council in 1994, where she ran unopposed twice and served on the Council until her election to the office of Mayor in 1998. She currently chairs the Madisonville-Hopkins County Economic Development Corp., is treasurer of both the Board of West Kentucky Corp. and the Pennyryle Area Development District, and serves on the Executive Board and Legislative Committee of the Kentucky League of Cities. She is a member of the Noon Kiwanis, Madisonville Business and Professional Women's Club, and a charter member of Leadership West Kentucky. Karen and her husband, Bill, attend the First Baptist Church, where she is active in the vocal and hand bells choirs.



Robert Michael "Mike" Duncan is Chairman and CEO of Inez Deposit Bank. His professional career as attorney and banker has coincided with more than 30 years of work for Republican candidates for local, state, and national office. Mr. Duncan has been a delegate to four Republican National Conventions (RNC) and chaired the RNC Committee on Contests for the 2000 convention. He has worked in various campaign positions for Senators Jim Bunning and Mitch McConnell and for Presidents Richard Nixon, Gerald Ford, Ronald Reagan, and George Bush. He also served as Regional Chairman for Kentucky and nearby states for President George W. Bush's campaign. Mr. Duncan and his wife, Joanne, are the principal owners of two community banks with six offices in eastern Kentucky, and their bank monitoring program has received national media attention. His civic activities have included Chairing the Boards of the Governor's Scholars Program, Morehead State University, and Alice Lloyd College; and President of the Kentucky Bankers Association. Mr. Duncan holds degrees from Cumberland College and the University of Kentucky.



Bill Goodman began hosting *Kentucky Tonight* on the Kentucky Education Network (KET) in September 1996. Prior to joining KET, Mr. Goodman ran a business in Glasgow, Kentucky. Before that, he served as News Director at KPRC-TV in Houston and worked in various capacities at WTVF-TV in Nashville. Mr. Goodman is a graduate of Western Kentucky University.



Dr. Merl Hackbart is Professor of Finance and Public Administration at the University of Kentucky. In addition, he is a member of the Kentucky Council on Postsecondary Education, a Senior Fellow at the Council of State Governments, and a Senior Policy Advisor to Governor Paul Patton. He also serves on the Kentucky Consensus Forecasting Group and is the Director of Graduate Studies for the doctoral program in Public Administration. His research focuses on public financial management, debt financing, and municipal securities. He has previously served as State Budget Director for Kentucky, Special Assistant to the Chancellor, Associate Dean of the Gatton College of Business and Economics, and Director of the Martin School of Public Policy and Administration.



Anne R. Joseph is the Director of the Kentucky Task Force on Hunger. Prior to this post, she served as Residence Hall Director at Berea College, consultant to the National Child Nutrition Project, and organizer of the Kentucky Welfare Rights Organization and edited for both the Brown University Press and World Publishing Company, and served as an editorial trainee for Doubleday and Company. Ms. Joseph received her B.A. from Hunter College and her master's in library science from the University of Rhode Island. She is a former board member of the Kentucky Association of Older Persons and the League of Women Voters of Kentucky, where she also chaired the state Human Resources Committee, the State Legislative Network, and the Pro-ERA Initiative. She was a Co-Founder of the National Anti-Hunger Coalition, the Council of Southern Anti-Hunger Coalitions, and Kentucky Action for Human Needs. Ms. Joseph is a former Co-Chair of the Human Services Council of Lexington-Fayette Urban County Government, the Social Services Committee of the Kentucky Appalachian Advisory Council, and the People for People Campaign: Every Kentuckian Counts. She is a former member of the Steering Committee of the Campaign to End Childhood Hunger and a convenor of the Kentucky Welfare Reform Coalition. Her awards include Outstanding Woman of the Year from the American Association of University Women, Central Kentucky Chapter; Berea College Service Award for Promoting the Ideals of Berea College; the Raymond M. Wheeler Award for Distinguished Service in Fighting Hunger in America from the Food Research and Action Center in Washington, D.C.; the Hunter Hall of Fame in Recognition of Outstanding Achievement; and the YWCA Woman of Achievement Award.



Mary E. Lassiter currently serves as the Deputy Executive Director of the Governor's Office for Policy Research and a Special Assistant to the State Budget Director. She served as a financial analyst in the Office for Financial Management and Economic Analysis, which operates the Commonwealth's investment and debt management programs, for 15 years. Ms. Lassiter has served as a special assistant to Governors Wilkinson and Patton on economic development and workers' compensation issues. She holds both a B.A. and M.B.A. from the University of Kentucky. Ms. Lassiter lives in Woodford County with her husband, Frank, and two children, Mary Beth and Ben.



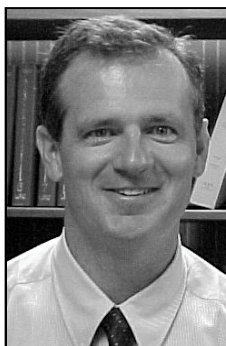
William M. Lear, Jr. is Managing Partner of Stoll, Keenon & Park, LLP, a member of the firm's Real Estate and Land Use Planning Department, Litigation Department, and Equine Law Department and practices in the areas of zoning law and litigation and equine law. Mr. Lear is generally recognized as one of the state's leading real estate development and municipal law practitioners. He has represented numerous developers and property owners in major real estate projects throughout Kentucky. Mr. Lear served as a Representative to the Kentucky General Assembly from 1985 to 1994. In that capacity, he introduced and secured passage of numerous bills relating to economic development, including the nationally recognized House

Bill 89 creating the Kentucky Economic Development Partnership. While serving in the Kentucky General Assembly, Mr. Lear also participated in drafting and successfully sponsoring bills, resolutions, and amendments covering such diverse subjects as planning and zoning, privatization of infrastructure, tort reform, insurance reform, corrections, ethics, drunk driving, licensure for various types of professions, campaign finance, election reform, environmental law, seat belts, and mental health. He has served on the following boards, special committees, and task forces: Chairman of the Economic Development Committee for the House of Representatives (1991-94); Co-Chairman of the Committee on Economic Development Structure and Programs for the General Assembly (1991-92); Chairman of the Commerce and Economic Development Committee for the National Conference of State Legislatures (1992-93); Delegation Leader of the European Workforce Training and Business Assistance Study Tour for the National Conference of State Legislatures (1992); Co-Chairman of the Investing in People Project for the General Assembly (1993); Co-Chairman of the Governor's Tax Policy Commission (1995); Chairman of the Board of Directors of the Greater Lexington Chamber of Commerce (1995-96); member of the Board of Directors and Executive Committee of Lexington United (1995-2000), and Chairman of the Board (1996-2000); member of the Board of Directors of the Kentucky World Trade Center (1992-1996); member of Networks Team for the Kentucky Strategic Plan for Economic Development (1994-96); and member of the Governor's Agricultural Policy Task Force (1993). Mr. Lear was educated at Davidson College (B.A., 1972), and received his law degree from the University of Kentucky (J.D. with high distinction, 1975). While studying at the University of Kentucky, Mr. Lear was elected to Order of the Coif and served as Editor in Chief of the *Kentucky Law Journal*, 1974-1975. Mr. Lear is listed in *The Best Lawyers in America* and is a member of the Fayette County, Kentucky, and American Bar Associations.



Dr. Lawrence K. "Larry" Lynch is Emeritus Professor of Economics at Transylvania University. He earned a B.S. in 1962 and a Ph.D. in Economics in 1967, both at the University of Kentucky. Dr. Lynch was Senior Economist and Division Manager at Spindletop Research in Lexington from 1967 to 1974 before leaving to teach at the University of Kentucky's Martin School of Public Administration. He moved to Transylvania in 1979. In 1996, he was named Kentucky Professor of the Year by the Carnegie Foundation for the Advancement of Teaching. Lynch now teaches part time at Transylvania and serves as consultant to a number of law firms and government agencies. His work is principally in the areas of taxation, economic-impact analyses, and forensic economics. He has served

as Tax Consultant to the Kentucky Legislative Research Commission since 1975. His recent research includes, "The Economic Effects on Kentucky of Ohio River Casinos" (with Paul A. Coomes), a report prepared for the Kentucky Economic Development Corporation in September 1999.



Dr. Charles W. Martie is currently Director of the Division of Research and Development at the Kentucky Revenue Cabinet. His current research includes tax policy, data warehousing, and the application of data mining techniques to tax compliance. He was formerly an Associate Professor and Chair of the Economics Department at Quinnipiac College in Hamden, Connecticut. He has also served as an economist in the Bureau of Economics at the Federal Trade Commission, specializing in antitrust and merger policy. He earned his doctorate in economics from the University of Connecticut. His publications include research in local government organization, tax policy, and health economics. He currently resides in Scott County with his wife and two children.



Representative Harry Moberly, Jr. is an attorney. He represents Kentucky's 81st House District. He attended Eastern Kentucky University, where he received a B.A. with high distinction. He earned a J.D. from the University of Louisville. He is a member of the Naval Reserve, the Kentucky and American Bar Associations, the Elks, the Greater Richmond Area Chamber of Commerce, Pi Sigma Alpha, National Political Science Honor Society, and the Governor's Commission on Full Equality. Representative Moberly was named one of the Outstanding Young Men of America in 1981 and earned the Kentucky Education Association Central District Friend of Education Award in 1982. He currently serves as Co-Chair of the Subcommittee on Tax Policy for the Kentucky General Assembly.



Representative Stephen Nunn has served Kentucky's 23rd House District (Barren and Warren Counties) since 1991. He is an insurance agent from Glasgow and attended the University of Kentucky. Representative Nunn received his B.A. from Transylvania University and attended the University of Louisville School of Law. He is a member of the Board of Directors of the YMCA and the Museum of the Barrens and a member of the Glasgow Rotary Club, Glasgow Chamber of Commerce, Boy Scouts of America, Glasgow D.A.R.E. Program, Glasgow Education Task Force, Ducks Unlimited, Independent Insurance Association, and the Glasgow Environmental Awareness Committee. Representative Nunn also served as a White House intern in 1974.



Dr. James R. Ramsey currently serves as Professor of Economics and Public Administration at the University of Louisville and is on loan from the University of Louisville to the Patton administration, serving as the Governor's Senior Policy Advisor and State Budget Director. Previously, Dr. Ramsey has served as Vice Chancellor for Finance and Administration and Professor of Public Administration at the University of North Carolina-Chapel Hill, Vice President for Finance and Administration and Professor of Economics at Western Kentucky University, and as the state's Chief Economist. Dr. Ramsey has taught at the University of Kentucky, Kentucky State University, Middle Tennessee University, and Loyola University. Jim is a native of the Louisville area. He has his undergraduate degree from Western Kentucky University and his Ph.D. in economics from the University of Kentucky. Jim is married and has two daughters, ages 17 and 13.



Steven S. Reed is an attorney with Wyatt, Tarrant and Combs, LLP. He is a member of both the firm's environmental law and commercial litigation practice groups. He concentrates his practice in those areas as well as general litigation. He is a former United States Attorney for the Western District of Kentucky having served from 1999 to 2001. Before joining the Justice Department, he served as Deputy General Counsel to Kentucky Governor Brereton Jones (1991-1993). Mr. Reed has served on the Governor's Commission for Health Care Reform, the Kentucky Crime Commission Executive Committee, and as a delegate to the Sixth Circuit Judicial Conference. He is presently a member of the Prichard Committee for Academic Excellence and the Louisville Public Library Foundation's Board of Directors and currently serves as Vice Chair of the University of Kentucky Board of Trustees. Mr. Reed is a member of the American, Kentucky, and Louisville Bar Associations. He received his B.A. *magna cum laude* in 1983 from Western Kentucky University and his J.D. in 1986 from the University of Kentucky College of Law.



Senator Richard A. "Richie" Sanders is from Kentucky's 9th Senate District. He is a farmer and commercial sales representative. Senator Sanders attended Western Kentucky University. His memberships include the Edmonson Saddle Club, Franklin Rotary Club, and the Kentucky Cattlemen's Association. He currently serves as Co-Chair of the Subcommittee on Tax Policy for the Kentucky General Assembly.



County Judge Executive Larry Whitaker was once a community development planner in central Florida in one of the fastest growing areas of the United States. He studied planning at Murray State University. He's now the McLean County Judge Executive and also serves on the Governor's Smart Growth Task Force. He is chairman of the bipartisan Planning Work Group Committee. His wife, Teresa, and he have two daughters.



Dr. David E. Wildasin holds the Endowed Chair in Public Finance at the Martin School of Public Policy at the University of Kentucky and is also a Professor in the Department of Economics. He received a B.A. in economics from the University of Virginia and a Ph.D. in economics from the University of Iowa. His teaching and research interests are in public, urban, regional, and international economics, with a special emphasis on federalism. His recent research includes work on fiscal policy issues in the context of European economic integration and on intergovernmental fiscal relations in developing countries. In addition to previous appointments at the University of Illinois, Indiana University, and Vanderbilt University, he has held visiting positions at such institutions as Queen's University (Canada), the Universite Catholique de Louvain, the University of Bonn, the University of British Columbia, the Ecole des Hautes Etudes en Sciences Sociales (Marseille), the Economic Policy Research Unit at the Copenhagen Business School, the European University Institute (Florence), Gadjah Mada University (Indonesia), the University of Helsinki, the University of Munich, the Norwegian School of Economics and Business Administration, the University of Tilburg, and Uppsala University.

ACKNOWLEDGMENTS

We wish to thank *Dr. Gordon Davies*, who at the last moment agreed to deliver our keynote address, as a fearless substitute for *Dr. Bill Fox*. Dr. Fox had to cancel the day before the conference to undergo open-heart surgery. We appreciate Dr. Davies taking time from his busy schedule to contribute his expertise and wisdom to our conference audience.

We appreciate the contributions of the following individuals who served as panelists or moderators for the conference: *Walter Baker, Evelyn Boone, Jack Brammer, Robert Cox, Karen Cunningham, Mike Duncan, William Fox, Merl Hackbart, Anne Joseph, Mary Lassiter, William Lear, Larry Lynch, Charles Martie, Representative Harry Moberly, Representative Stephen Nunn, James Ramsey, Steven Reed, Senator Richie Sanders, Larry Whitaker, and David Wildasin.*

We also want to acknowledge the important contribution of Kentucky Educational Television (KET). *Bill Goodman, Renee Shaw*, and the rest of the KET staff were a pleasure to work with as we developed the conference. KET went through considerable effort to televise the panel discussion portion of the conference so that not just the conference attendees but a wider audience of Kentuckians could benefit from these discussions of *Financing State and Local Government: Is Kentucky Making Progress?*

We are grateful for the services of *Doug Terry, Sally Everman, Janice Clark, Tom Hampton, and Bobby Sherman* of the Legislative Research Commission staff. They made the enormous job of executing this conference easier. We are also grateful to *Bess Councill* of ExecSec, who transcribed the many hours of audiotapes for this document. Finally, we are grateful for the services and staff at the Capital Plaza Holiday Inn.

FINANCING STATE AND LOCAL GOVERNMENTS

FUTURE CHALLENGES AND OPPORTUNITIES

NOVEMBER 14, 2001

presented by

KENTUCKY

LONG-TERM POLICY RESEARCH CENTER

WELCOMING REMARKS

Representative Stephen Nunn

Chairman of the Board of the
Kentucky Long-Term Policy Research Center

Welcome this morning. I'm Representative Stephen Nunn, Chair of the Long-Term Policy Research Center's Board for this year. We're so glad you're here for the eighth annual conference of the Kentucky Long-Term Policy Research Center. This morning and this afternoon we're going to discuss financing state and local government, future challenges and opportunities. Before we start, I'd like to introduce the Board of the Kentucky Long-Term Policy Research Center, an outstanding Board that helps guide the Center's staff and its activities. If those persons here would stand as they are introduced I would appreciate it. Betty Griffin, Vice Chair; Diane Hancock; Mary Lassiter; Donna Moloney; Jim Ramsey; Tom Buford; Alice Forgy Kerr; Gippy Graham; Evelyn Boone; Ron Carson; Paul B. Cook; Dan Hall; Jennifer Headdy; Sheila Kruzner; Penny Miller; Robert Sexton; and Alayne White. They do a great job for the Center. Would you please give them a hand? On behalf of the Center, we really appreciate your coming to what we hope will be an informative and educational conference.

Because we live in an era of unprecedented change, the need to anticipate and prepare for what lies ahead has become central to the work and mission of government. Increasingly, knowledge and information are the tools that enable policymakers in every arena to glimpse the shape of things to come, seize opportunities as they arise, and avoid costly mistakes. To bring a future-oriented perspective to decisionmaking in the Commonwealth, the General Assembly created this Center in 1992. After careful planning and preparation by its Board of Directors, the Center was launched in mid-1993. Unique to the U.S. public policy landscape, the Center strives to enrich understanding of trends and forces influencing the future of the Commonwealth and to lend a long-term perspective to policymaking. The work of the Center includes research, policy analysis, strategic planning, communications with all branches of government, and public outreach, like we have here today.

Some of the things the Center has done in the past includes a biennial report on trends influencing the future of the Commonwealth, research into timely topics of importance to the state's future, *Visioning Kentucky's Future*, and *Foresight*, a quarterly publication. The Center also does a statewide scanning program and public outreach. You saw as you came in today there are over 25 published reports about most of the important issues facing the Commonwealth. Some of those publications include: *Education and the Common Good*, *Social Benefits of Higher Education in Kentucky*; *Kentucky and the New Economy and Challenges for the New Century*, *The Conference Proceedings*; *What Next for Kentucky Health Care?*; *The Future Well-Being of Women in Kentucky*; *Kentucky's Teachers*; *Entrepreneurs and Small Business*; and many, many more. I dare say that if you don't know what's going on at the Long-Term Policy Research Center, then you don't know all you need to know about what's going on in Kentucky.

We've got several legislators here that I'd like to introduce, including Representative Jim Bruce, Chairman of Banking and Insurance in the House; Representative Mike Cherry, instigator of trouble everywhere he goes; and Senator Tom Buford. I don't know if Representative Tim Feely is here this morning. I know he's coming. At this time, I'd like to introduce the Director, Representative Jody Haydon, and Representative Gippy Graham, one of our good Board members here. Welcome Gippy. Mike Childress is the Director of the Center and has been our Director since the Center's inception. He does an outstanding job as you can tell by the quality of the work and the publications that the Center produces. At this time, I'd like to turn the morning program over to Mike and thank him and our staff for all their hard work. Please welcome Mike Childress.

Michael T. Childress
Executive Director
Kentucky Long-Term Policy Research Center

Thank you and good morning everyone. My name is Michael Childress and I'm the Executive Director of the Kentucky Long-Term Policy Research Center. I'm sorry that we held this conference on such a beautiful day. Typically, when we have our conferences in November, it's gray, rainy, cold, windy, and nasty. I just have some housekeeping items that I wanted to mention. Perhaps one of the most important items relates to when the food will be ready and where it will be located. We have a lot of people here today. There are approximately 350 to 360 people registered for the conference. We sincerely hope that there will be enough chairs for everyone. So far, it looks good. I see some empty chairs over here. The lunch buffet is going to be open at 11:45 this morning and we're actually going to have two buffet stations. One will be just outside the ballroom and the other will be in the waterfall area by the bar. There are tables set out there that will accommodate about 50 to 60 people and KET is going to televise the noon-time activities, which will include our keynote address as well as the presentation of the Hellard Award. As Representative Nunn indicated, we have several of our publications on display on the table out there. I encourage you to take some of them home with you.

If there are local government people here who are interested in getting education units or professional development credits, we have worked with the Department of Local Government and you can get a number of credit hours for attending this conference. Please see Billie Sebastian at the front desk and she'll get you squared away on that. At about 10:45 we're going to take a break. Because of the limited space available here and the large number of people at this conference, we're forced to use the back two sections of this ballroom for our break-out sessions. So in your packet you'll find information about the location of the three breakout sessions. The first session "Business Taxation in Kentucky," will be in Ballroom Two, which is the room closest to me. The second breakout session, "What is the Tax Burden on Kentucky's Families and is the Burden Distributed Fairly?," will be in the far ballroom. The third breakout session "What are the trends in local taxation and what does the future hold?," will be in Kentuckiana One and Two, which is down the hall and to the left of the bar area. So we're going to be busy pulling the curtains here at about 10:45. This conference is really linked very tightly with a project and a report that we at the Center, along with others, have been working on now for several months, relating obviously to this topic. Many of the people, if not all of the people, who are presenting today have written chapters. There will be a report available on our website today minus the conclusions and the executive summary, which should be posted in a few days. Our website is www.kltprc.net and there are a series of buttons on our home page. One of them is entitled New Information. If you click on that New Information page, it will take you to a hyperlink of this report and you'll find a PDF version or electronic version of all of the chapters. There are eight chapters available and if you check back in a few days you should also find the conclusions.

Now I want to recognize some of the people who have worked on this project and simultaneously, I suppose, introduce our first two speakers. I'd like to thank Dr. Gena Toma for her support and the University of Kentucky Martin School for Public Policy and Administration which has lent great support and encouragement to this project. Professor Dave Wildasin is an economist and an Endowed Chair in Public Finance at the Martin School. Dr. Merl Hackbart is also an economist and a professor with the Martin School. Both of these gentlemen have joint positions, and Merl is also with the Department of Economics at the University of Kentucky. The Office of the State Budget Director has been very supportive of this project and many conversations with them have really helped clarify our thinking about what the salient issues are. They've provided additional support through Dr. Chuck Martie, who has written a chapter as well. I'd also like to recognize Dr. Jim Ramsey and his staff for their support in this effort as well. Dr. Larry Lynch, who is the General Assembly's consultant economist, has helped us understand some of the important issues as it relates to the taxation of business in Kentucky. I'm sure that I have left some people out. Many people have assisted us and for that we are grateful. At this point, Dave, I'd like to turn it over to you and Merl, and we'll go from there. Thank you, everyone.

WHAT DOES THE IDEAL TAX SYSTEM LOOK LIKE AND CAN IT BE ACHIEVED?

Dr. David Wildasin
University of Kentucky

I am going to be speaking for about 15 minutes. I'm going to try very strenuously to stay within my time limits. Merl, you'll remind me if I start to encroach on your time. I won't go through extended acknowledgments, but I am extremely grateful for many people, including the people here in this room, for assistance along the way, helping me learn about tax policies in Kentucky. I've tried to make effective acknowledgments in my report, but I'm sure some people will go unacknowledged inadvertently.

I have the modest task of talking about how to achieve the ideal tax system and, especially since it's such a nice day, I think we should plan to leave in about 15 minutes here and go out and enjoy the rest of the day. And I'll be able to provide you with the answer to this question on the very next slide, which I hope is visible to the people in the back. No, not really? Well, I'll try to repeat everything that's on the slides.

In brief, describing the ideal tax system is not terribly difficult. We simply have to find an efficient way of raising revenue that's very fair and, while we're in the process of doing that, we may as well do it in a very simple fashion. Of course, that's easily stated, but not necessarily easily achieved. I'm reminded of the famous Fable of Aesop about the mice trying to figure out how to deal with the cat that was always prowling around. One mouse said, "Well, what we need to do is put a bell around the cat and then we'll know when the cat's coming." This is a great idea except, of course, as the moral of the story went, it's one thing to propose and another to execute. In tax policy, the real task is actually in *achieving* efficiency and equity, especially because in many cases these key economic criteria or principles for thinking about tax policy come into conflict with one another. I'm going to try to explain a bit more about what we mean by efficiency and equity in taxation. As I do that, it will probably become apparent how these principles can come into conflict. I hope to spend at least a little time towards the end talking about some applications of these principles in the context of sales taxation, which is discussed in Chapter 3 of the upcoming report.

As I've already indicated, the two key economic criteria for thinking about tax policy can be summed up in the words "efficiency" and "equity."

Efficiency fundamentally refers to the notion that we don't want our tax system to drive economic behavior. We don't want people responding specifically or solely to tax incentives in making economic decisions because that's going to cause a waste of scarce economic resources. But the immediate problem that we encounter is that virtually all taxes *do* affect incentives in various ways and we're going to be faced with the difficult task of finding out how to do the least damage with the tax system that we ultimately end up with. Equity refers to the notion that the tax burden should be distributed in a fair fashion, but a fundamental problem there is trying to decide exactly what you mean by a fair distribution of tax burdens.

Both of these economic criteria really revolve around a fundamental economic objective of policy, which is to improve economic well-being or economic welfare, as economists use that term. Welfare just means economic well-being. And that is something which really depends on lots of other factors that we often talk about but which themselves are not the fundamental objectives of economic policy. For example, people need income in order to be well-off. We need to have business activity for people to be well-off. We need for there to be employment. We care about people's health, we care about education, we care about the provision of other kinds of public services. All of these are important and when we discuss tax policy oftentimes we talk about the effects of taxes on jobs or on the ability to finance public services and so forth. No one of these things is the key ingredient in economic welfare. They all come together and one of the difficulties is trying to balance them one against another.

Let me speak a bit more specifically about the concept of efficiency. The key idea of economic efficiency is that we will promote economic well-being when we make economic decisions that are driven by real economic benefits and costs, not by artificial incentives that are introduced by tax policy or other government policies. That usually means that we want to interfere as little as possible with market-driven resource allocation because markets provide important signals about the real economic costs and benefits of different kinds of decisions. A key and perhaps the most important contribution that economics can make to thinking about policy is that economic behavior is not something that just happens. It results from people responding to the incentives and rewards that are provided to

them, including tax policy, expenditure policy, and regulatory policy. I'll just run through very quickly a couple of examples of areas where fiscal policy affects economic behavior.

With regard to labor market decisions, one way that tax policy can affect economic behavior is by affecting people's work effort. The amount of time that people want to spend working and the amount of effort that they want to expend in doing productive activities depends partly on whether they reap the rewards of those efforts. Many taxes interfere with that, for example, income taxes. Sales taxes also do that. The more expensive goods and services are, the more you have to work to get the goods and services, and the reward to your effort is diminished on that account.

On the expenditure of public policy, which I will just mention in passing here, means tested benefits programs, as one example, certainly affect work effort incentives.

Another way in which fiscal policy affects labor is through its impact on the incentives to locate employment activities in different places. Is it desirable to work in a particular city, in a particular county, in a particular state? Why should you work in one state or another? Well, there are many factors that come into play but among the factors that people may well take into account are the fiscal incentives that state or local policies provide and that's something which also affects economic behavior. We sometimes use the word "competitiveness" to refer to the notion that policies affect the location of economic activity. I think that's fine, but I would prefer to think of that simply as one aspect of the economic incentives that policies create; locational incentives are among the many incentive effects of policies.

Similarly, taxes affect the allocation of capital. Capital comes from people trying to save and accumulate wealth, behavior which is certainly affected by tax incentives. Taxes affect both how much you want to save and where you want to live, if you're a wealthy person. Individuals have to decide the right place to engage in wealth accumulation. If you're a business, you have to decide the right place to invest and how much to invest. These are also aspects of economic behavior that are significantly affected by tax policy.

All of these are relevant issues to think about when we consider the personal income tax, the corporation income tax, and many other kinds of taxes as well. I hope at the end to talk about the sales tax, so I should mention here that we should also understand that tax policy affects consumption behavior. When we tax different kinds of goods in different ways we cause incentives for people to change their consumption expenditures. This may also affect employment and production of different kinds of goods and services and, of course, there are cross border or interstate aspects of consumption behavior as well, including the vexing issue of taxation of e-commerce and interstate sales.

Let me turn now to talk about equity for a moment. The fundamental question here is that if we're going to collect tax revenue, we have to distribute the burdens among taxpayers somehow. What's the best way to do that? What's a fair way to do that? I start off in my report with some quotations from some famous people. One of them is Oliver Wendell Holmes, who said "taxes are what we pay for civilization." But there's always the question as to who exactly is going to pay for civilization, and I'm all for civilization, but maybe I would rather you pay a little more for it than me. Senator Russell Long worked at the Senate Finance Committee in Washington for many years and he had a famous quote. He said, "Tax reform means don't tax you, don't tax me, tax the man behind the tree," which is the *real-politik* version of thinking about equity.

How are we going to distribute tax burdens among people? That's a complicated question. There's no sort of simple solution to that problem, but I would like to mention some key ideas that are oftentimes the basis of a lot of our thinking about what is fair in taxation. There's the concept of the ability to pay, which says that some people have a greater ability to bear tax burdens than other people and we should allocate tax burdens in accordance with the ability to pay. That's frequently used to justify some form of income taxation, but it's not completely obvious that income is the right measure of ability to pay. We might want to tax people on the basis of how much they consume or how much wealth they have. Another sort of fairness principle in taxation is known as the "benefit principle" which says that people who benefit a lot from public services ought to be the ones that pick up the cost of public services. It's fair—as sort of an exchange between taxpayers and the public sector—that if you're getting a lot out of the government, then you should be putting a lot into the government. The difficulty with the benefit principle is that it's often difficult to determine exactly what the benefits are from public services of various kinds.

Related ideas are the concepts of vertical and horizontal equity. The principle of horizontal equity says that we should impose tax burdens so that people who are similar in relevant respects bear similar amounts of tax burdens. We shouldn't arbitrarily say, for example, that people who consume this particular kind of good, or who are employed in this particular way, or businesses that invest in this particular kind of activity ought to have tax preferences that aren't extended to other similar kinds of consumers, workers, businesses, and so forth. This is oftentimes summarized in brief as the principle of "equal treatment of equals." And this is at least one case where basic tax principles may not come into conflict because one of the things we don't want to do, for efficiency purposes, is to create artificial fiscal incentives for particular kinds of investment, particular kinds of consumption, and so forth. When we have a system which is horizontally equitable, it is sometimes said to be "neutral" in its impact. It minimizes the fiscal incentives to do one thing rather than another thing. So here's a case where one

important equity or fairness principle might actually coincide with or support the efficiency principle. Whereas horizontal equity refers to people that are similar, vertical equity refers to people that are different, and it says that people that are different should be taxed in different fashions, so that there is an appropriate differentiation of tax burdens. But the sticking point here is to try to figure out what is the proper amount of differentiation of tax burdens.

To show how these basic tax principles can come into conflict, take the example of progressive taxation. Do we want to argue that progressive taxes are fair? If we think they're fair, does this mean that they're good policy? Well, we have to decide. How progressive do you want the tax system to be? What will limit the desired degree of progressivity? Maybe the rich should pay more. But the more we tax the earning of income, the more we're going to exacerbate the efficiency problems I mentioned before. We're going to distort people's decisions about whether to earn income and whether to invest and save. We'll distort incentives for high-income households about whether to locate in a high-tax jurisdiction. Thus, we run into the difficulty of the so-called "equity-efficiency trade-off." This implies, among other things, that the ability of government to redistribute tax burdens, to achieve what some people might consider a fair distribution of tax burdens, is limited because in the attempt to do that, we're going to impose various efficiency costs through adverse incentives in work effort, savings, investment, and locational choices.

There are other criteria for taxation that are also important that I'll mention very briefly. I think they're important because they're relevant for economic welfare and ultimately for efficiency and equity. We want a tax system that is simple. It should be transparent. It promotes accountability of public officials. We want to make compliance costs reasonable. It has to be adequate to fund desired expenditure levels.

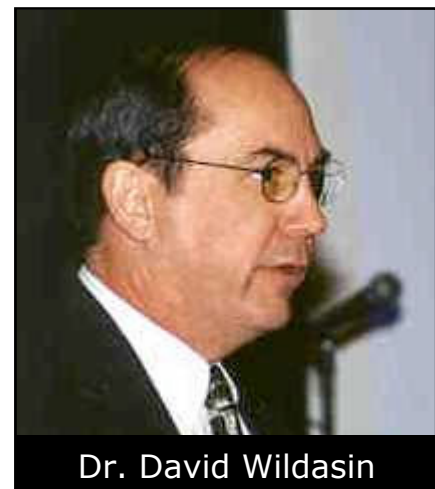
I do think it's useful in considering tax policy issues to somewhat separate the issue, where you can, of how much we're going to impose in taxes from how we're going to collect whatever taxes we decide to impose.

Whether we're going to have a big government or a small government is a very important question, but it's a somewhat separate question as to how we're going to raise the revenue for the government that we ultimately end up settling on. It's useful to talk sometimes about the *structure* of taxation as distinct from the questions of tax *levels*. Competitiveness I've already touched on and won't mention further here.

Let me conclude in my remaining minute and 15 seconds here by talking a little about the sales tax, which I think is an interesting case where some of these principles might be applied and also where they might come into conflict.

In Kentucky we have a sales tax which taxes some kinds of transactions, but not others. Most notably, we exempt services, or intangibles, from taxation, but we tax tangibles—sales of tangible goods of various kinds. Some people say we should broaden the base. Maybe we should include services in the tax base. I'll suggest in a moment that we may want to *narrow* the tax base in some ways. But before we try to settle that question, we have to determine what we want this tax to do. We normally think of the sales tax as a tax on consumption, and that's a reasonable sort of thing to try to tax. But it appears that in Kentucky, and actually in many other states as well, a lot of sales tax revenues are collected from sales, not to consumers, but to businesses. It is very difficult to estimate this with any precision, but it appears that in Kentucky consumers may pay as little as half of the sales tax revenue that is produced by our sales tax system, with the other revenue being produced from taxes on sales from one business to another, what are called intermediate goods transactions or business-to-business transactions. That is not taxing final consumption. We do tax tangible goods at the level of consumer purchases, and subject to many exemptions and complications, we also tax them at the level of business purchases. We don't tax services at the level of consumers or at the level of businesses. We don't effectively tax out-of-state transactions and e-commerce. We say we do through the imposition of the use tax, but few pay the use tax, especially consumers. So as a practical matter, we don't. So that's what the current sales tax system is, in very broad terms.

What would we like to do, if we wanted to try to tax consumption of households? Well, we'd like to tax consumption of tangible goods, which we do. We'd also like to tax consumption of intangible goods, which we don't. We'd like to be able to reach consumer purchases from out-of-state and e-commerce transactions and so forth, which we don't do very effectively. In those respects, it would be desirable to broaden the sales tax base. These are things that we ought to tax that we don't. On the other hand, we don't really want to tax business-to-business transactions involving tangible goods, services, or other kinds of purchases, either. And so in those respects, our system is not really doing what we want it to do. Ultimately, sales taxes do fall on consumption in some fashion or other. When business-to-business transactions are taxed, those taxes become a cost of doing business for suppliers who ultimately, through a series of transactions, produce goods and services for consumers. So, indirectly, these taxes fall on consumers by taxing upstream business purchases. But, by taxing these upstream transactions, we're producing a distribution of tax burdens on final consumption that piles up through repeated taxation in some cases,



Dr. David Wildasin

and does not in others, in a very haphazard fashion. We don't really know what these tax rates ultimately are, but we've tried to make some rough estimates and it appears that for some kinds of final goods, the cumulative tax rates might be as high as 10 or 12 percent because of repeated taxation in upstream stages. In other cases, the taxes are virtually zero. We have in practice a very uneven and differentiated distribution of tax burdens operating through this system because we're not just taxing final consumption, but also taxing intermediate goods transactions. Ideally, if we wanted to reform this, we might try to avoid the taxation of business transactions. We'd also like to capture all consumers' purchases. But I guess the question is, can we bell this cat?

In brief, it's one thing to propose this and another to find effective ways to administer such a tax. We could, for instance, have more exemptions of business transactions. I have to at least get this word in. As I was reading about the Kentucky sales tax, I learned what ratite birds are. Ratite birds include emus, ostriches, and rheas. They are exempt from taxation under the Kentucky sales tax among the 60 exemptions listed in "Kentucky Tax Facts." I suspect that there may be some representatives of the ratite bird industry here today and I don't mean to single them out, but we could, instead of having the current 60 exemptions, expand this to 120 or 180. That would be one way to try to limit the amount of taxation of business-to-business transactions. We could also try to enforce the use tax on consumers. Or we could think of major administrative reforms like the introduction of something like a value-added tax. So I would say in conclusion that improving the efficiency and equity of the sales tax is possible, at least in principle, but dealing with compliance issues and administration of those changes presents a significant challenge. Thus, we have seen that sales taxation involves equity issues, efficiency questions, and compliance and enforceability issues. This exemplifies the difficulties we're usually going to encounter as we try to balance basic tax principles one against another. Thank you.

TAX REFORM IN KENTUCKY AND THE OTHER STATES

Dr. Merl Hackbart
University of Kentucky

Good morning. I'm Merl Hackbart, and I appreciate the opportunity to participate in this very important conference. The financing of state and local government has been and will continue to be a major issue facing the citizens of Kentucky. State and local government finance includes a number of dimensions including intergovernmental grants, bond and debt financing, and special revenue sources. However, the main issue of state and local government finance continues to be the search for the ideal tax structure that Dave just talked about, a tax structure which will meet the financing needs of Kentucky's state and local governments and do so in an efficient, fair, simple, neutral, and competitive manner. This morning I'll attempt to provide a historical perspective of our efforts to design and implement a tax system for Kentucky state government. In so doing, I will try to identify some of the successful efforts we have had in implementing comprehensive tax reform, as well as our efforts to achieve less aggressive objectives in times when Kentucky adopted incremental changes or reforms to make our tax structure more consistent with our common views of what constitutes a good tax structure. In providing this overview, I will also briefly consider tax changes enacted by other states during the past decade. These changes and trends may be informative regarding the emerging state finance tax and tax issues.

Tax reform is not a new issue. In fact, Kentucky and other states have pursued tax reforms for decades. State tax reform has been undertaken in response to a variety of changes. In Kentucky, we have attempted to adjust our tax structure in response to changing economic conditions and structural changes in our economy. We have transitioned from an agrarian economy to a manufacturing economy, and more recently, employment growth has been the fastest in the service sectors. As we view the future, leaders are focusing on the new economy and the tax issues that the new economy may present.

Tax reforms have also responded to changing demographics and the aging of our populations. Kentucky and other states' citizens are aging, and this change has implications for the design of an optimal tax structure. Like other states, Kentucky has seen some good times and some not-so-good fiscal times. Faced with changing fiscal conditions, we have increased taxes and decreased taxes, but in all these actions, we have attempted to maintain an adequate tax system. In addition to the other changes, federal-state fiscal relations adjust to change. The role of state government continues to adjust to changes in the federal government programs and priorities. Oftentimes the adjustments in these relationships have tax policy implications as well. In addition to the fundamental economic fiscal demographic trends, changes in the past we have fostered have dealt with other trends and factors as well. Factors, nonenvironmental factors, and tax reforms have dealt with items such as national tax reform trends or waves, including the tax cap rewrite of the 1970s. We have also responded to major changes due to tax drivers, issues such as specific court cases, the need for additional resources, and major taxpayer concerns. In response to all of these factors, Kentucky, like other states, has responded in a variety of ways. We've responded by efforts to enact comprehensive tax reform initiatives involved in the fundamental restructuring of our tax base. Such initiatives tend to be supported by a policy driver. Unfortunately, comprehensive reform efforts are rarely successful. Kentucky, like other states, has also enacted incremental reforms and changes which often tend to focus on single issues, which often result in minimal tax base changes, and are often supported by single issue constituencies.

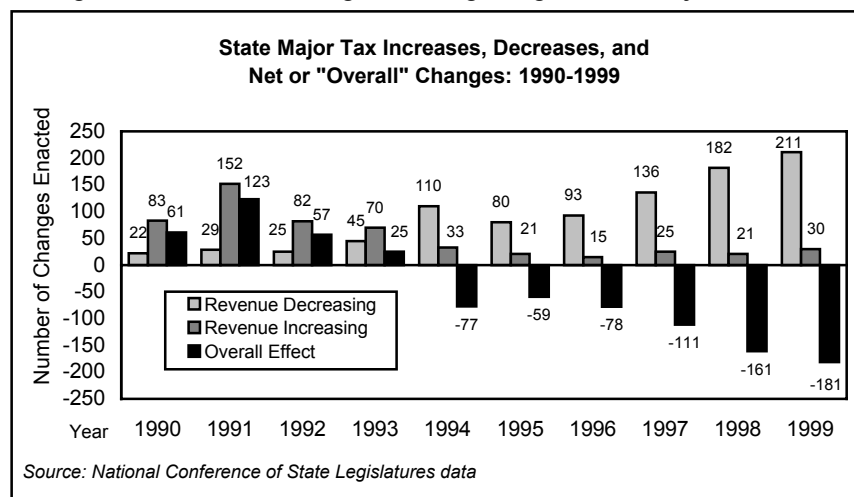
What constitutes reform is not clear. Are tax code changes just changes or changes based on the tax principles that Dave Wildasin just talked with us about? Overuse of the term reform appears to have created a credibility problem for true reform. As a result, when the term reform is used it may engender cynicism and may make true reform much more difficult. Comprehensive reform in Kentucky in the 1900s was very limited, applying reasonable criteria of change in the tax base as a result of efforts to change the tax system in accord with at least one major tax principle. A restructuring of Kentucky's base by at least 5 percent suggests that there are probably only four comprehensive reform efforts in Kentucky that were successful in the 20th century. Reform of the 1930s was the

first one of these. The reform of the 1930s, including the 1936 enactment of Kentucky's personal and corporate income taxes, was introduced after the repeal of the 1934 gross receipt tax. This was driven by a combination of the economic effects of the Depression and concern about Kentucky's heavy dependence on the property tax, which was over 60 to 70 percent of Kentucky's revenue as late as the 1920s.

The second major reform effort of our previous century was in the 1960s. The 1960 reform legislation was enacted during Governor Bert Comb's administration and was driven by education finance needs and a strong desire to broaden our tax base. The 1960 reform legislation introduced Kentucky sales tax on tangible goods and was initially a very broad-based and fundamental change to Kentucky's tax structure. The 1970 and 1972 reforms were driven by concerns regarding the equity of the sales tax and involved the exemption of food and prescription drugs from that tax. It made the sales tax much less regressive. This reform was also structured in such a way to modify our overall structure by the introduction of the severance tax, which was introduced to some extent to offset the loss of the sales tax revenue exemptions. The fourth comprehensive reform occurred in 1990 and was the result principally of the 1989 Supreme Court decision which declared Kentucky's system of education unconstitutional. The 1990 legislation increased the sales tax and enhanced the progressivity of the income tax. A proposal to broaden the sales tax was defeated, so the opportunity to modernize Kentucky's sales tax failed during that session.

The common thread of these major reform initiatives was a driver, which assisted in gaining the popular, and perhaps the political, support for major tax reform. While these comprehensive reform efforts were the punctuations for the century, incremental reform was more commonplace. Interspersed between the 1960s and 1970s were reforms, including actions that began to reduce the breadth of Kentucky sales tax. In fact, in the late 1960s, we have the first in a long series of special sales tax exemptions legislated. Between the reforms of the 1970s and the major reforms of 1990 were: the enactment of House Bill 44, which was Kentucky's version of the property tax cap legislation which spread from Iowa to California through Proposition 13 and eventually included some 20 states; the 1985 special session of the General Assembly, which made several changes in the sales tax; changes in the corporate income tax rate; revisions in Kentucky's depreciation schedules; and changes reflecting Kentucky's demographic changes. The elimination of the inheritance tax on property passing from decedent to the surviving spouse was one of a series of legislative acts of that nature. Interspersed between the 1920s and the 1990s were numerous other incremental changes reflecting single-issue concerns, some of which were tax-principle-based while others reflected concerns of selected groups of taxpayers, which probably bore little resemblance to true principle-based tax reform. While a long-term history is helpful in gaining an understanding of how and why our current system of taxes evolved, perhaps near-term history and recent national trends can also be revealing about how we might achieve reforms necessary to modernize our tax structure.

The National Conference of State Legislatures data indicate that in the 1990s we had a decade of numerous tax reforms and changes. The NCSL data indicate that there were approximately 1470 individual tax law changes enacted by the 50 states impacting the three major tax types: the personal income tax, the corporate income tax, and the sales tax. If all state tax changes were included, the number of tax changes would have increased dramatically. During the decade, tax-reducing actions regarding the three major taxes exceeded the increases for those three major



taxes by 941 legislative actions to 527. Tax-based changes were the most common reform of the state's sales and income taxes in the 1990s, with 619 followed by 201 administrative changes and 150 tax rate changes. This chart depicts the overall tax reform and trends for the decade in terms of revenue increases and revenue decreases. The blue columns indicate tax increases. The green columns represent tax decreases. As you will note, the light blue chart, which basically dips below the grid in the latter years, indicates the net effect in terms of increases

versus decreases for the 1990s. As shown from 1990 until 1993, tax increases regarding the three major taxes exceeded decreasing actions.

The economic downturn of the 1991-92 period and the associated fiscal stress experienced by the states most likely led to the tax increases by the states to raise necessary revenue. By contrast, from 1994 to 1999, tax decreasing legislation dominated state income and sales tax policy changes. The tax trend was facilitated by and probably coincided with the strong economy of that period which enabled the states to reduce taxes while meeting

expenditure needs. Kentucky followed that trend and reduced several taxes, including the enactment of private pension income tax exclusion and an increase in the income tax standard deduction as well as other reforms. The Kentucky tax reductions reduced total state revenue for fiscal year 1999 by an estimated \$190 million. By the way, for the current fiscal year, the estimates suggest that those same cuts—reductions—represent over a \$300 million reduction in our current tax base. Tax reform has been, is, and will continue to be a major state policy issue. The continued focus on state tax policy is appropriate as our economy, our demographics, and our intergovernmental fiscal relations adjust. They are continually changing and our tax policy should reflect those changes.

Perhaps the more difficult question is: will we make our tax structure adjustments and will we make the right changes? History can help us design policies and strategies for change. I will offer four observations regarding our tax history. First, the term tax reform has lost its punch through overuse as a marketing tool for almost any type of tax change that we have enacted or attempted to enact. Second, history suggests that comprehensive reform is rare and very difficult to achieve; unless aided by a driver, it is seldom achieved. Incremental reform by contrast is frequent but may lack a policy goal and it may or may not lead to tax-principle-based reform. Passing tax changes because other states have may or may not enhance the equity, simplicity, adequacy, or competitiveness of Kentucky's tax structure.

I also offer the following suggestions regarding tax reform and change. First, I believe we might change the overused tax reform term and replace it with tax modernization, a term that perhaps more adequately reflects the tax-principle alignment of our tax system with our changing economy, our changing demographic characteristics, and our changing values. Second, I would suggest, we should look for and connect with drivers, if comprehensive modernization is to be pursued. Third, if comprehensive modernization is not achievable, we should be pursuing directed-incremental modernization. In such a case, we would set goals for modernization, establish a blueprint, and then adjust our tax policy in line with those goals incrementally. Of course, the 1995 tax commission effort is an example of such a strategy. Fourth, I would suggest we should be cautious and analyze the impact of national tax reforms before adopting them in Kentucky. State economies are different. State economic structures are different. State demographics are different. Current tax structures are different across the many states. Tax values differ from different communities and different states. Therefore, optimal solutions for one state may not necessarily be the optimal solution for Kentucky. Whether we will successfully modernize and adjust our tax structure in the future is the question. History will eventually provide the answer. Thank you very much.



Mr. Childress

Thank you very much, Merl. Now I'd like to welcome Dr. James Ramsey. Dr. Ramsey is the State Budget Director and a professor of economics and public administration at the University of Louisville. Thank you for coming this morning, Dr. Ramsey.



Audience ponders taxation.



Board Chairman, Representative Stephen Nunn, and wife Tracey

ADMINISTRATION PERSPECTIVE ON TAX MODERNIZATION IN KENTUCKY

Dr. James Ramsey
Kentucky State Budget Director

I think the biggest fan of the Kentucky Long-Term Policy Research Center is Governor Paul Patton. He reads all your reports and documents cover to cover. We appreciate the work that you do and the fact that you force us, as public policymakers, to focus on difficult issues and certainly, as has already been pointed out to us, tax reform. As Merl has indicated, tax modernization is one of those difficult issues. My job for the next few minutes is to talk about the administration's perspective on tax modernization, so I'm going to try to use the word that Merl has suggested, modernization, as opposed to reform. To give you a little bit of a history of where we've been and where we think we want to continue to be, which has been consistent, is that upon adjournment of our first legislative session back in 1996, the Patton administration retreated. No, we didn't get discouraged and give up, quite the contrary. The Governor and his newly formed cabinet held a retreat to identify and to clearly articulate our policy initiatives for the next four years and yes—hopefully for the next eight years.

Now in retrospect, as we look back, we think maybe six years would have been about the right time frame with the budget cuts. A six-year term might have been better than an eight-year term. The vision that drove our strategic planning process was to design and implement public policy initiatives that would help increase economic opportunities and the standard of living for all Kentuckians over the next 20 years. We initially identified five strategic initiatives and for each strategic initiative we identified specific tactics and time lines. These initiatives have been promoting economic development. We began almost immediately after that retreat working on reform of our workers' compensation system. We're still very focused on economic development issues today and are looking at all of our firm-specific and geographic-specific economic development incentive programs now and trying to do a re-evaluation of those. Our second strategic initiative was improving our education product and right after our reform of workers' compensation, we began working on House Bill 1, Reform of Postsecondary Education. Our third strategic initiative was building self-sustaining families. Here we've made a lot of progress with welfare reform, with TANIF, with implementation of the Workforce Investment Act at the federal level and other workforce initiatives. Our fourth strategic initiative was reducing crime and its cost to society. We've made a lot of progress, we believe, in several areas here, particularly in the juvenile justice area and in eliminating the consent decree that had been placed upon Kentucky. Our fifth strategic initiative was strengthening the efficiency and operation of government. A tactic defined early on for strengthening the efficiency and operation of government was the modernization of our tax system. We believed that this was important in 1996, and we continue to believe that it is important now as we approach 2002. We have tried to bring about change in our tax system over the last six years, both incrementally, as Merl has discussed, and also through comprehensive reform, specifically during the 2000 session, the Revenue Fairness and Recovery Program that we submitted to the General Assembly.

The blueprint for many of our ideas has been the recommendations of the 1995 Kentucky Commission on Tax Policy, again that Merl referenced. However, as it turns out over the last six years, most of the tax changes that have been implemented have been tax cuts that have cost and reduced the General Fund money, in the current year, approximately \$280 million. Merl referenced a figure greater than \$300 million; that's all fund sources. These tax cuts have created great concern about the elasticity or adequacy of our revenue base. Now, let's be crystal clear, we're not calling for a tax increase. Rather, we believe that modernization of our revenue system is more important than ever if we as a state are to grow, prosper, and ensure for our children increased economic opportunities and an enhanced standard of living. Why do we believe this? Because our revenue structure is flawed. Forget the current budget shortfall. Nothing that we do from this point forward in the next two years will really help us with our budget issues. What we need to be concerned about are the long-term issues. In the long-term, we need a tax system that will grow and allow us to continue to move forward by investing in our people.

A number of thoughtful research papers have and will be presented to you today. You've already heard Dave talk about the characteristics of an ideal tax system, and you've heard Merl talk about a historical perspective of tax reform in Kentucky as well as other states in the last decade. So without plowing the same ground, allow me to cite a few examples of the flaws that exist in our revenue structure today. First of all, is our tax system fair? Let me give you four examples. The current individual income tax rate structure was established in 1950 when the average per capita income in Kentucky was \$990. We taxed the first \$3,000 of income at 2 percent, so it is clear that the individual income tax enacted was not intended to be paid by many of our working families. Today, our average per capita income of our people is over \$25,000, but our income tax structure has not been changed. So our lowest income families must not only file tax returns, to take advantage of the low-income credit, but most often must pay Kentucky individual income taxes at the highest marginal tax rate. Example two, we have legislated the exemption of prescription drugs from the sales tax to lessen the regressivity of the tax, or have we? If you buy your drugs at the local drug store, the prescription is exempt from sales tax. However, if you go to your doctor's office and the drugs are administered by your physician in their office, for example chemotherapy treatments, the sales tax applies. Examples three and four, if you are a Kentucky domiciled corporation, your corporate license tax is computed differently than if your company is domiciled outside Kentucky. And, of course, we're all aware that how a business is organized determines whether the corporate license tax is due in Kentucky or not. The issue of LLCs has been debated for the last two legislative sessions. In terms of the flaws of our system, is our revenue system structured to grow with our economy? Dave has talked about the sales tax, so let's begin there.

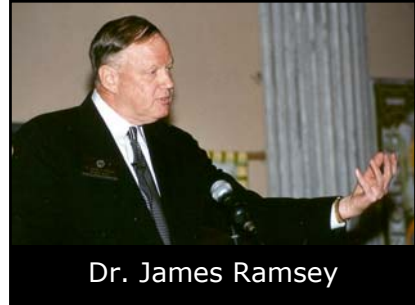
Consumer confidence is at an all-time low, resulting in less spending and no sales tax growth today. But this issue of the sales tax growth has been an issue for several years. As our friend Bill Fox has pointed out in his research, the sales issues facing states today are more deeply rooted than that of the current cyclical slowdown in the economy. As Dave has pointed out, consumer spending patterns have and will continue to change. We spend less of our disposable income on tangible goods that are subject to sales tax and more of our income on services that are not subject to sales tax. Remote purchases have become commonplace, both via catalogue sales and the Internet. The legal strictures of the United States Supreme Court in the Quill case impede our ability to collect these taxes that are legally due to us. I might note that this is not only a growth inadequacy issue but also a fairness issue. It puts our main street vendors in Kentucky at a competitive disadvantage with out-of-state sellers. We know, and it's been discussed already this morning, that we live in a changing business environment. Businesses today do more and more state and local tax planning to minimize their state and local tax liabilities. Mergers and deregulations are commonplace, often creating leakages in our sales tax. For example, the unbundling of sales transmission and distribution of natural gas to business purchases is costing the Commonwealth millions of dollars.

Finally, our tax base is eroding due to the total disregard of the federal tax policy impact on state and local governments. Earlier this year, the federal government passed a \$1.3 trillion federal tax cut over the next 10 years. Included in this was the phase-out of the federal estate tax, the tax to which our state's and most other states' inheritance taxes are coupled. The impact on Kentucky alone with this lost income will be \$253 million over the next 10 years. The current economic stimulus debate in Washington has also disregarded the fact that the enactment of an accelerated appreciation for businesses and other changes that are being discussed for businesses to benefit in this slowing economy will have minimal stimulative impact on the economy. It will also cost Kentucky, like other states, over \$100 million in the next year or so. Is our tax system suitable for the new economy that Merl mentioned? Again, our tax system is flawed. While the Baird's analysis of Kentucky's business taxes indicates that our business taxes do not place us at a competitive disadvantage with other states, a more detailed review of this analysis shows that we are disadvantaged for those businesses that are key to our growth in the new economy, the industries emerging as areas of focus in the strategic planning process that Dr. William Brundage is taking us through.

So my first point to you this morning would be our tax system is flawed. My second point is the obvious—for tax modernization to occur, it must be a bipartisan issue, and I mean bipartisan in the broadest sense. It cannot be a Democratic issue nor a Republican issue. It cannot be an issue for our businesses only, nor for our working families only. It must be an issue for all Kentuckians. For modernization to be bipartisan, it must be revenue neutral. As has already been pointed out, we've cut some taxes, and in the aggregate over the last six years in all funds, we've cut over \$1.7 billion from our tax base. In the 2000 Session of the General Assembly, taxes were raised by expanding the 6 percent sales to interstate phone calls and by the failure to statutorily repeal the switch access charge on the telecommunication industry. These two actions restored about \$100 million to our General Fund revenue base. So we've cut taxes and we've raised taxes and, while the cuts have exceeded the increases, we must wipe the slate clean to move forward. It's important to recognize that revenue neutrality today must not, nor should not, mean that we cannot restore the elasticity that permits our tax system to grow with the economy and hence permit the continued investments needed to be made in education and other critical services in the future.

Finally, my third point would be that tax modernization cannot be an executive issue only. We have been focused for six years on tax modernization. We've not been successful. We applaud the 2001 Session of the General Assembly for creating the Appropriations and Revenue Committee's Subcommittee on Tax Policy. We appreciate the diligence of the cochairs, Representative Moberly and Senator Sanders, and you'll hear from them in just a

moment. Their work to date has been thorough, deliberate, and thoughtful. They have at their disposal one of the foremost tax experts in the nation, Dr. Bill Fox. We have pledged our assistance and resources to help where appropriate. We recognize the difficult challenges that the subcommittee faces. The weak economy and the resulting state's budget problems may divert our attention from the real issue; that is, our tax system must be improved now if we, as a state, are to grow and prosper over the next 20 years. While our challenges to tax modernization are significant, I'm encouraged. First, the Governor and Executive Branch are no longer the only ones talking about the subject. Second, today we're having thoughtful and deliberate discussions with an all-time record attendance. The work of the Long-Term Policy Research Center is important in shaping this critical public policy issue. Third, as I've already noted, the General Assembly created a special committee, indicating the recognition of the leadership of the General Assembly that this is an important public policy issue. And, fourth, our newspapers and other opinion leaders are encouraging modernization efforts, as witnessed by editorials as recently as yesterday in the *Lexington Herald-Leader*.



So perhaps we've taken step one in a process, a process not too dissimilar from what Merl has indicated as necessary in terms of modernization of our tax system. That is, perhaps we've established the predicate for change. We were told two years ago when we tried to undertake comprehensive reform as part of our budget proposal that we were unsuccessful because we did not establish the predicate. If we've established the predicate in step one, then perhaps we can move to step two, which is finding the fix. As we've already been told, there's no magic bullet or formula for the fix. But step two cannot take place until step one has been achieved. So with the work of the last year, both of the Long-Term Policy Research Center and the General Assembly, I think we're moving forward in a significant and meaningful way. When you have had the opportunity to review the work of our different authors, as it appears on the web, and then later in hard copy, you'll see that the material provides us a nice blueprint to follow as we move forward in trying to find a fix. Thank you.

Mr. Childress

Thank you very much, Jim. We're going to slightly revise our schedule and we're going to take a 15-minute break now. When we come back at 10:15 we'll have Jack Brammer moderating a discussion with the Cochairs of the Subcommittee on Tax Policy. Thank you.



Mr. Jack Brammer and Rep. Harry Moberly.



Senator Richie Sanders, and conference attendees.

LEGISLATIVE OUTLOOK

Moderator

Jack Brammer

Panelists

Representative Harry Moberly, Jr.

Senator Richie Sanders, Jr.

Mr. Brammer

I've had many opportunities to ask many questions. One of my favorite questions comes from the English writer, G. K. Chesterton. He once said, "Do you take things in life for granted or do you take things in life with gratitude?" I'm grateful to be here with you this morning and these two state lawmakers. We're here this morning to have a discussion on a subject familiar to all of you: taxes. We have with us this morning Representative Harry Moberly, Jr., a Democrat from Richmond who is the Chairman of the House Appropriations and Revenue Committee and has been a member of the State House since 1980. We also have with us Senator Richie Sanders, a Republican from Franklin, who was in the State House from 1991 to 1996 and moved to the Senate in 1996. He is Chairman of the Senate Appropriations and Revenue Committee. Together these men are Cochairs of the Subcommittee on Tax Policy. That is a Task Force created by the 2001 General Assembly to look at ways to improve Kentucky's tax system. I will begin with a question for Representative Moberly and then have an answer from Senator Sanders, and then we will ask questions from the audience. If you have a question, please come up to the far microphone over here on my left, or, if you're in the back, hold up your hand and someone with a wireless microphone will get to you. We're asking for short succinct questions and not sermons to these two lawmakers. The first question, Representative Moberly, the Subcommittee on Tax Policy held its first meeting last April 26. After that meeting, both of you said you were optimistic that Kentucky lawmakers will enact comprehensive tax reform in the 2002 General Assembly. Both of you said the panel will be able to come up with a plan to improve Kentucky's tax code that will achieve bipartisan support in the 2002 General Assembly. What is that plan and are you still confident that it will achieve bipartisan support in next year's legislative session?

Representative Moberly

Thank you for the question, Jack, and I appreciate having the opportunity to be here at this conference and appreciate the work that Representative Nunn is doing in leading the Kentucky Long-Term Policy Center this year. I'm still confident. I guess you want short and succinct answers from us as well.

Mr. Brammer

If you have the plan, go for it. Take as long as you want.

Representative Moberly

We don't have a plan yet, but the one key word I think you mentioned there and the one definition that we have to talk about is that term comprehensive. I don't recall—and maybe you have a direct quote, Jack—but I don't recall saying that I was confident that we would enact or come up with a plan to enact comprehensive tax reform. I think I did say, or I meant to say at the time, that I was optimistic that we could come up with a plan that would improve Kentucky's tax system. We've taken a lot of testimony since that meeting. I've learned a lot about the various aspects of our tax system and of course we set out with a pretty optimistic goal, I think, a bold goal, really, to come up with a plan that would achieve bipartisan support. Senator Sanders and I agreed that we would have to come up with something realistic that could achieve that support. I'm still confident that we can come up with a plan. I do not think that some people will consider the plan that we finally propose or recommend to be their definition of comprehensive.

After looking at the various issues with the Kentucky tax system and the tax structure, and also having the opportunity to watch how this economic downturn affected our structure and compare that with other states, I think I have a different idea as to where we need to go and what's achievable in the next session. I think what we have seen, even though we have faced a \$700 million shortfall during this biennium is that the Governor and Jim Ramsey have done an outstanding job making the cuts necessary to meet that shortfall. The shortfall has also demonstrated that we've had a well-managed state government and we have planned well with our budget reserve trust fund.

Having the opportunity during our deliberation to see how our tax structure stands up to a shortfall and comparing that with other states, I've come to the conclusion that our tax structure is not as bad or is in as much need of reform as we originally thought it was. If we compare how it has stood up to this crisis, this economic downturn, I think we've fared much better than many other states such as Tennessee and North Carolina. One of the reasons for that is the diversity of our tax system. We rely on a diversity of taxes. Of course, the sales and the income tax are our primary revenue sources, but we're in much better shape, for instance, than a state like Tennessee. I saw Larry Keeling a little earlier and I don't know if he's writing the editorials for the *Herald-Leader*, but one of the things that they constantly talk about is extending the sales tax to services. We've looked at that very closely because I was of that mind when we started that we ought to at least take a very close look at that and we have. But for a number of reasons that we can discuss in more detail, I think we've concluded that a broad extension of that is not a good idea. If you look at what's the most unfair area of our individual income tax, where we do not treat similarly situated people the same, I think you'd have to say the pension exemption. You know a retired person or couple making \$85,000 gets a \$35,000 or better exemption, where a two- or three-person family working couple with a child doesn't get that exemption. So is that fair? Are we likely to change that exemption? No, because of the policy reasons that created it in the first place and because of the political factors associated with that.

So as you look at the major areas where there might be possibility of reform, we have narrowed those areas considerably and what we may finally recommend may not be what some people consider comprehensive. What we are focusing on now is what we'd like to call tax modernization. When we look to the future, we look at what our growing areas of economy are, try to bring more elasticity to our system, look at the new economy and what we need to do to encourage that, try to promote fairness as much as possible, and look at the areas we can do that and get it done politically in a bipartisan way as you mentioned. What I'm getting around to is saying that I'm still confident that we will have a very significant proposal to modernize our tax system. But I don't think some people will consider it to be that term comprehensive. I would consider what I have in mind, and probably what Senator Sanders has in mind, significant but maybe not a complete overhaul which is what we imply with the term comprehensive. So I'm still confident as we move ahead that we can achieve a recommendation that will have a chance, an opportunity, for the political support we need on both sides of the Capitol to get finally passed into law. Thank you.

Mr. Brammer

Senator Sanders, how would you assess the work of the Subcommittee and do you have confidence that they'll be meaningful tax reforms?

Senator Sanders

As Representative Moberly said, it depends on your definition, but I'm confident that at the end of the session, April 15th, that we will be able to do something that does modernize our tax system. Dr. Fox, and unfortunately he's not going to be able to be here today, but that's the consultant that we have jointly hired to do any analysis of our tax system, has stated that we do have broad-based instruments in our tax system. But our basis with those instruments may be a little narrow, and we may have too high a rate on some of those instruments that we have to use in our tax base. I think one of the most significant things that Dr. Fox has found in his research since 1996 is that the revenue the state brings in has not kept up with the economic growth of the state. We've asked him to do an analysis at the end of the day if we do no tax modernization where will our budget be in his estimate in 2004 and 2006 and on into the future because we think that's something that we need to know. One of the goals if we are able to come up with some tax modernization, will be that it will have to be revenue neutral and will have to be bipartisan. Even Governor Patton stated that in his address to the members of the General Assembly. If we are able to come up with some tax modernization, it will not help us short-term with our budget deficit that we find ourselves in now, but it will be more long-term, hopefully growing with the economy.

Another thing that Dr. Fox talked to us about was telecommunications. That was a big issue during the last regular session and it's going to be a big issue this time. I was under the impression, starting off, that if we were able to enact some telecommunications modernization, we would just be able to enact that and that would be something that would stay in place for a long time. Dr. Fox has told us that that industry is changing so much and so much is going on that that's going to be something that we'll have to keep a good handle on and be able to make adjustments probably every year through the system. But the telecommunications issue would be a key component if we do come up with some tax modernization. Of course the cable industry is going to bring suit saying that they are being treated

differently than the satellite dish folks, so that could play a part in anything that we come up with as far as telecommunications reform. Also, there's been a lot of talk about low-income Kentuckians, about how our income tax hits the low-income Kentuckians harder than the surrounding states. We just had the Legislative Research Commission do a report that said if you look at the overall tax burden, sales tax and the whole gambit of issues, we're really not too far out of line in the overall tax burden on low-income Kentuckians. So those would be some of the challenges that we face. It will be very difficult, but I think that Representative Moberly and I have a good relationship and that we will try to put something together that would pass through both houses of the General Assembly.

Mr. Brammer

Both of you mentioned tax modernization and I gather you're not ready to announce details of any plan yet as you're still working on a plan. But let me ask you to speak for yourself and not for the Subcommittee. What tax changes should be implemented to improve the system?

Representative Moberly

Well, when we look at tax modernization, Jack, Senator Sanders has already mentioned one area, telecommunications, that we need to address. We're not taxing them in a manner that makes too much sense at the present time. We had a proposal in 2000 that actually passed the House. It had to do with repealing all the current local and state taxes on them and just levying one excise tax, and that would have the effect also of bringing in people who are not now taxed that ought to be taxed. So that would level the playing field for all the telecom people. And, as we know, this is a very fast-growing area and we need to start bringing in everybody that has telecommunications, so there's not this inequity about which the suit was filed that Senator Sanders referenced. Now we have run into a problem because of the changing nature of the industry. The excise rate that we passed in the House was 7 percent, too low now to make this proposal revenue neutral. In fact our consultant, Dr. Fox, has said that the rate might have to be as high as 8.1, so we will have to do something. We think that's politically prohibitive to have that sort of rate on an excise tax. So we'll have to work with the telecom industry to come up with something that makes sense politically and is still revenue neutral. Even if it is revenue neutral, currently we think because of the growing nature of the industry and bringing in those who are not taxed, which is unfair, then that will be a growth area and will provide some of the elasticity that we were talking about earlier.

We passed House Bill 44 in 2000 with respect to property tax. Right now the state cannot take advantage of the growth of new property on the state part of the property tax. We need to put ourselves in the same situation that the locals are in where, even with HB 44, they can take advantage of new property and growth and that would help the state. That's also an elasticity issue as well. We need to look at the fact that Limited Liability Corporations (LLCs) are exempt from the corporate license fee and get special treatment with respect to income tax. A lot of corporations are switching over to LLCs in order to avoid tax. We need to look at and shore that up, and I think that is another issue that has to do with elasticity. So in those areas, we would expect to either gain revenue or we would expect to put ourselves in a better position to grow with the economy and to achieve the elasticity that we're looking for, that one-to-one ratio so when the economy grows our governmental revenues will grow. We're going to be looking at all those areas now even where it might cost us some money. Senator Sanders has already mentioned the lower end of the individual income tax. That is a challenge for us because we have gone along assuming, for a period of time and before this committee was meeting, that we have one of the highest burdens imposed on our lower-income people in the nation. And, if you just look at our individual income tax, there is no question that is true. But other reports say that if you look at the totality of our system, we're not out of line at all and we're fine when you measure our tax burden on lower-income individuals. We need to look at the facts here. We don't need to just be caught in something that we think we ought to say. We need to look at what the real facts are and see whether the burden on our lower income people is higher than it should be or if we determine it's not, based on the totality of our system, then we need to decide if we ought let one of our taxes, our individual income tax, impose that higher burden. And those are decisions that we'll have to make in our recommendations and the next General Assembly will have to make.

We're also looking at trucking and how our tax structure has basically driven out any sales of large trucks in our state and that's a fairly small issue, I think. We're looking at our commitment, which has been made but never delivered upon, to start phasing out or to end the state portion of the property tax on motor vehicles. This was a commitment that we started looking at when the constitutional amendment was passed, and we still have a commitment unfulfilled at this point. Senator Sanders and I are both committed to looking at that as we move forward. We want to hear from Commissioner Brundage, the Commissioner on the New Economy, to look at what we need to do to make sure that our tax system properly incites those new economy ventures that we want to bring to our state. That's closely related to what we've been trying to do with Bucks for Brains and those sorts of initiatives that are intended to spur higher paying jobs, new economy jobs in our Commonwealth. But if our tax system does not support that, then we have something that we need to look at there. And finally I would say we cannot hide our head in the sand and fail to consider alternative sources of revenue, which is not directly on point

with our tax system. But it has to do with the adequacy of our revenue and whether we have enough revenue to do some of the things we need to do to make our system fair. We're going to have to look at the proposal that's going to be brought forward for increased gaming at race tracks in the Commonwealth. It's a little off subject, but it bears on this whole idea of adequacy of revenue and what surrounding states are doing. Just the 10 Indiana riverboats are bringing in \$22 billion a year. Wagering nationwide for Thoroughbred racing is just \$15 billion a year. So those Indiana riverboats and Ohio and Illinois gambling are sucking money out of the surrounding states like a giant vacuum. Now, whether we're just going to sit by and let that idly happen and let that revenue that we could have in our base just go out-of-state, we at least need to consider. Thank you.

Mr. Brammer

Senator, you had mentioned telecommunications and tax relief as ways to modernize the tax system. If you have any other comments on that and if you could also comment on alternative sources of revenue, particularly expanded gambling in the state.

Senator Sanders

One of the things I think that we do need to look at is venture capital in the state. If you look at the numbers, Kentucky is 48th or 49th in the venture capital investments we attract to the state. I think there are probably designated to be some changes made in our tax system to try to attract more venture capital, and I think that goes hand in hand with Dr. Brundage and the new economy. The other thing that we did pass legislation on last session was to participate in a national model in trying to get a handle on what's going on with Internet purchases. Dr. Fox has said if we do nothing, and we're limited to what we can do, that we were estimated to lose an additional \$85 million this next year and 90 percent of that, so Dr. Fox says, is actually business-to-business transactions. It's not people purchasing things over the Internet, but 90 percent of it is actually business-to-business. So that's something that we, as a state, are participating in with 38 other states in a compact to try to get a handle on what's going on with the Internet purchases over the Internet. And that's something all states are facing with declining sales taxes. Tennessee has been especially hard hit with that because they depend so much on sales tax for their tax base. As far as alternative gambling goes, I think that the horse industry has made a case that something needs to happen if it is to remain a significant part of Kentucky as it has in the past. Other states are offering higher purses for races to take place in their state. West Virginia is offering higher purses than they do at Kentucky tracks for races. Other states are also now offering incentives for foals to be born in their states. If, as a state, the horse industry is going to be a significant part as far as agriculture goes—actually the horse industry has surpassed tobacco as the number one agriculture entity in the state with the decline in and the cutting of the quota that tobacco has seen over the past three or four years. That will be a very, very tough issue. The horse industry has asked for some tax relief and we had the owner/CEO of the Turfway track testify at our last meeting. The question was asked, "If we do all the tax relief that you're asking us to do here today, is that enough to keep your business viable?" And he said, "No." But that will be a very, very tough issue.

Mr. Brammer

We would welcome any questions from the audience at this time. Yes, sir.

QUESTIONS, ANSWERS, AND COMMENTS

Questioner

School funding is one of the biggest issues that the state faces. There are a couple of glitches in the school funding formula. One of them is if you have local property assessment, because one formula is based on property assessment. As individual properties go up a certain amount, if they go up 10 percent in one year, the state formula assumes that that 10 percent increase in local assessments will result in a 10 percent increase in the local taxes and therefore the state will hold back 10 percent. The problem with local districts is they can't raise their local taxes by 10 percent when that happens. They can only go up by 4 percent without going to the voters. So the glitch there is the base formula holds back 10 percent in state money, but local tax sources can only increase their local revenue by 4 percent and that's a problem in the formula. There's another problem in the formula in that each school district has a maximum amount of taxes or tax breaks that they can post. Now this varies from district to district. So one district might have a maximum property tax rate of 70 cents that will be prevented by the state from going entirely to them. A neighboring district may have 80 or 90 cents property tax because it is allowed in the formula. Now that seems like an unequal treatment of taxpayers because taxpayers in one district have their tax rates capped by the state at a lower level than taxpayers in another district. And it also affects which district a business wants to locate in. Certainly it wouldn't want to locate in a district that had the maximum tax rate with lower levels in surrounding

districts or neighborhoods. So I just wanted to point out a couple of those glitches in the school funding formula because as the money gets back on all state budgets, school budgets, even if it's held at the same level as this year, for next year they'll be losing money because you've got increased top-rated bonds and all that stuff.

Mr. Brammer

And your question, sir?

Questioner

Is there any answer when we have these kinds of tax issues in front of the school budget?

Representative Moberly

The division of the state formula has not been part of our deliberations, but the Department of Education is looking at that. They have a consultant looking at it, and I think they're ready to share some things with us. Of course, they have considered the things that you've mentioned and those things have been discussed at some other meetings. It would necessarily cause some redistribution of the money and would be controversial. Some would be for it and some wouldn't, but I do think you have correctly identified some of the problems in the formula. It's important that the Department, as they are doing now in the State Board of Education, look at that and try to make the changes necessary that are fair and make sense, at the same time making sure that whatever redistribution occurs does not upset the other goals that we're trying to accomplish with the SEEK formula. So it's not really a question of problems to be fixed. They have to be fixed within the context of what we're trying to do with the SEEK formula and all the goals we're trying to accomplish with it, and trying to adhere to the concepts of education reform. But, as I say, it's not been a part of the topic of our Tax Policy Issues Subcommittee, but the Department is addressing it now and it will be addressed, I think, on a continual basis.

Mr. Brammer

Do you have anything to add?

Senator Sanders

Well, my understanding is they have already come out with a report on that just recently. It's a pretty thick document. I haven't read it all, but overall they said that in their opinion there did not need to be any major changes to the SEEK formula, but I would encourage you to get a copy of that report from the Department of Education.

Mr. Brammer

I understand we have a few more minutes. Any other questions? Yes, sir.

Questioner

My question is "Why is it recently we had a surplus, and now we have a deficit?"

Representative Moberly

Many of my constituents are asking me "Well, aren't you Chairman of the Appropriations Committee and what's happened here? How come we had this surplus and now we have a deficit?" We budgeted based on the consensus forecasting. We have a very good consensus forecasting group in the state made up of experts, economists and others, and they do a good job, like their counterparts in other states—because economics is an art, not a science. They did not accurately predict the downturn that we suffered in November, and governmental revenues are based on the state of the economy. We talked a little bit earlier about the elasticity, trying to achieve that one-to-one ratio where when the economy grows, we get commensurate growth in our governmental revenue. We have lost some ground on that in the past, and we really didn't achieve as much with the upturn in the economy in the last few years as we could have if we had had a little more elasticity. But we're suffering the same problem as nationwide. It's the national downturn in the economy affecting governmental revenues, and it caused a shortfall in our budget because we budgeted based on the forecast of the consensus forecasting group. Of course, we would not budget on our own forecast because legislators are not experts. We budget on the basis of their forecast, the experts' forecast, and they did not foresee—as nobody did nationwide—the downturn that we began to suffer in November. Nobody could have predicted the September 11 events, which have clearly exacerbated that shortfall or that downturn in our economy. Hopefully, the economy will pick back up and I think at this point the forecasting group is projecting that it will pick back up in the next biennium. I will say that our budget will probably be sparse at least in the first year of the next biennium because a lot of our cuts have been made with one-time revenue and that has to be made up with recurring revenue when we budget for the next biennium, but the answer is because we forecast on the basis of experts and the experts did not foresee the downturn that we had in the economy.

Mr. Brammer

Richard?

Senator Sanders

Well, the other point of that is that since 1996 we have, as a state, cut a significant amount of taxes. We did the private exemption. We did the inheritance tax exemption. We raised the standard deduction. We did the provider tax. We did the provider tax for prescription drugs. We did the health insurance deduction. We did for the tobacco farmers, that they wouldn't have to pay any state income tax on any money that they got from a national settlement or from the Phase One money, because that was a bill that I sponsored because I represent tobacco farmers. We did the change of property tax on automobiles some. We did also the sales tax exemption for farm fuels. We had the jet fuel credit for large carriers. We did that for UPS and Delta Airlines, put a cap on the amount of revenue that they would pay at a million dollars to try to get them to expand in the state of Kentucky. So we've done some things ourselves. One question everyone asked, was "Where did the lottery money go?" We designated the lottery money to go for the KEY scholarships. That's for kids in high school to be able to get money to go to college, and that was basically a hit on the General Fund of about \$120 million a year. By our constitution, we're required to have a balanced budget. Now, in Washington, they're not required to have a balanced budget and certainly after what happened on September 11th, the focus is going on for national security, but we do have to make cuts in Kentucky whenever our budget is not balanced.

Representative Moberly

I might add, too, that the taxes that we have cut, the revenue that we have lost, was figured in by the consensus forecasting groups. So we did budget. It has caused us not to have the pad that maybe we would have thought we would have had, but the consensus forecasting group did figure that in. We budgeted in 2000 a strong bipartisan budget based on the recommendation of the revenue forecast for the consensus forecasting group, and it was a good example of bipartisan cooperation. The revenue estimates simply did not hold up, and they did take into account the taxes that we had previously cut.

Mr. Brammer

We have time for one more question. Yes.

Questioner

On the topic of gambling, ladies and gentlemen, let me ask a three-point question. OK? Number one, are you going to totally ignore the federal government's national gambling impact study which called for a national moratorium on gambling expansion as an economic strategy for the nation and for the state? Secondly, with regard to race tracks and their complaints about their competition, only Turfway is not profitable, and Turfway has historically had difficulties, but when Harrah's bought it, I listened to them swear to you all up one side and down the other that because they were so gifted at marketing gambling they could make that track profitable. They've not lifted a finger to make that track profitable as Ellis has with competition across the river from it. And, third, the Governor had an economic impact study conducted by PriceWaterhouse a year and a half ago which was unable to fulfill its contract by being able to explain the third part of the government's question in the contract that we granted that firm for \$250,000 to explain the social costs of gambling, which could be detrimental in the long run to the overall economy. The horse racing business accounts for 5 percent of our general gross domestic product, and there are other people who live in this state and other people who do business in this state. It is a very profitable form of income which the lottery has shown you, but in an economic downturn people don't gamble as much. So I don't think it's a very secure form of tax revenue.

Mr. Brammer

Correction, Harry?

Representative Moberly

Well, let me respond by saying that I was not advocating that we do that, but I was saying that we should not shy away from a full discussion of that. And I would think that the points you've brought up would be very much a part of that discussion. Now, with respect to the horse racing industry, I think it is a signature industry of this Commonwealth, and I think not only our racing but our breeding has been put at a disadvantage because of the purses and the inability to give additional money for Kentucky-breds, and we could have a long discussion about that. I think John Gaines from over at Lexington does a very good job of talking about all those issues. But it is an industry at risk, and if we don't explore ways that we can help that industry, then we'd be making a big mistake and would be losing a great part of our heritage. But I do think that you make some good points. Social costs would very much have to be discussed, but my point is Indiana is realizing \$350-\$400 million a year of revenue from this. Now

I don't know what their social costs are, but if we don't take a look at this, if we just hide our head in the sand, then we could be doing ourselves a great disservice. The issues you've made, our horse industry, and all of that ought to be fully debated, and then we ought to arrive at some decision based on our best judgment and that discussion.

Mr. Brammer

Senator Sanders?

Senator Sanders

Well, we've had the industry testify before the tax committee and Representative Moberly and I feel like it's our duty to make sure it is an open debate. We certainly will hear from both sides.

Mr. Brammer

Gentlemen, thank you, and thank you all.

Mr. Childress

OK. We're going to go ahead and divide this room up into a couple of sections and then the chow line will be open at 11:45, and we look forward to seeing you all there.

BUSINESS TAXATION IN KENTUCKY: TOO MUCH OR TOO LITTLE?

Moderator

Mr. Robert Cox, Governor's Office for Policy Research

Presenter

Dr. Larry Lynch, Tax Consultant to the Kentucky Legislative Research Commission

Mr. Cox

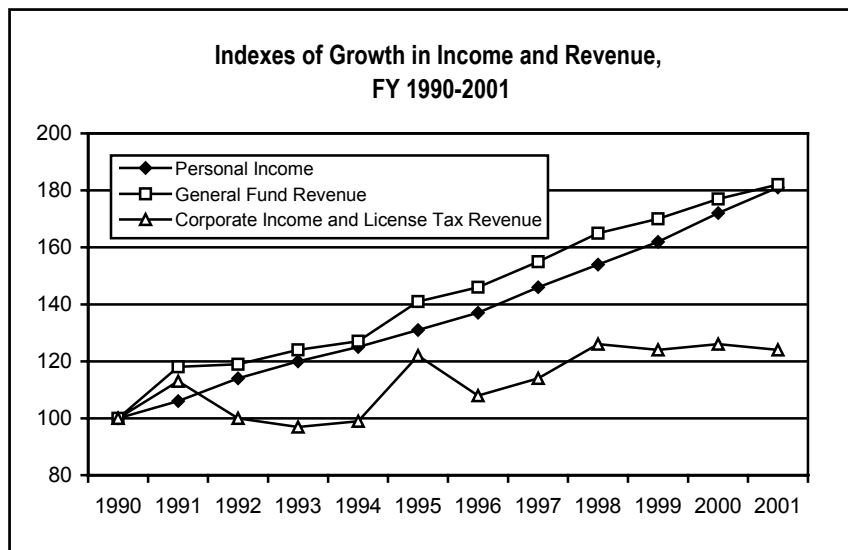
Businesses are only a hypothetical construct. We don't look at businesses as having what the economists call utility function. In other words, a business doesn't feel good or feel bad. The people who interact through a business relationship can feel good and can feel bad, depending on the level of business, but the business itself is hypothetical; it's an inanimate object. It's like, does business like that? We always say, business doesn't like this, or business doesn't like that. In the abstract, it makes about as much sense as saying, "Does that coke can like the fact that the temperature's too warm in the room?" I mean, a coke can obviously doesn't care and the business doesn't care. Who cares are the people who interact with those businesses. Typically, we divide those into three groups: the people who own the capital that are employed in the business relationship, the people who work with the capital employed in the business relationship, and the people who buy the goods and services that arise through that business relationship. All those people have what we call utility functions—that is, they can feel better or they can feel worse, depending on how the level of taxation breaks down.

Now the principal problem when you study this from an economist's point is when you put a tax on "business." We think, it's the old saw: businesses don't pay taxes—people pay taxes. We've all heard that and you go, yeah, yeah, yeah . . . what does that mean? Well, the incidence of a tax on business is going to fall on either those people who own the capital, people who work with the capital, or people who buy the products, and those are the people who interact with the business. We like to think in the abstract, that when we put a tax on business, that it falls on the owners of that capital. That is not necessarily the case, when you start analyzing it. You find that business taxes can affect not only the people who own the capital, but the people who work with the capital, and the people who buy the goods and products that are produced by that business. For that reason, business taxation is always going to be a controversial topic because we don't know or even agree necessarily which way the incidence of those taxes is going to fall. So you may think you're taxing business, you may think you're sticking it to those owners of capital, but in fact, what you may be doing is sticking it to the people who buy the products, and the people who work with the capital. So it's very important not only to look at the issue of how much business is taxed, but also the manner in which you tax business, because both things are very relevant.

Since the economic literature isn't a whole lot of help, it's left to the politicians to decide how we're going to tax business and who's going to pay for these types of taxes. I like to think of politicians as probably thinking they can divide taxes into taxes on people and taxes on business, as we've pointed out, but it's not always that clear. What you get is a dichotomy in terms of state taxes on business. On the one hand, it's a politically popular thing to say, "I want businesses to pay their fair share. I'm going to make the business support the actions of government, particularly if business benefits from those governments." But then on the other hand, we say we need all these incentives. On one hand we said we want to tax business, make them pay their fair share, but on the other hand, we come up with ways they can avoid paying taxes and we do this under various motivations. We want to give them incentives. We want them to invest, we want business to come here, we want to be friendly to them, and we want to make sure that we don't do anything to drive business away from the state. So it's a conflict between the level of business taxes and how you tax those businesses. I think Larry is going to have a lot to say about both of those. Since our time is limited, I'm going to shut up now and let Dr. Lynch give his presentation, and hopefully, we'll have time for a few questions and answers. Dr. Lynch.

Dr. Lynch

Thank you, Bob. I guess the question I was asked to address was, “Are business taxes too high or too low?” Two studies in the last couple of years have been done in Kentucky on business taxation. One found that our business taxes are about average with the states with which we compete for economic development. Another study found that our taxes were too high. I was asked to take a look at the business tax situation in Kentucky, both state and local. At first glance, since I deal with forecasting state revenue, I took a look at the two major state business taxes, the corporation license and income taxes, and compared them with the General Fund revenue and personal income, starting them all at a base of 100 in 1990. You can see what happened.



The General Fund has grown at about the same rate as personal income. But look at business taxes. Those two business taxes have done really poorly during one of the greatest expansions of the economy in U.S. history. So you say businesses are really getting away with murder here. But on the other hand, these are not the only taxes that businesses pay. These are the most visible taxes that businesses pay at the state level, but businesses also pay property taxes, sales taxes, and local taxes at the state and local level.

The next thing I wanted to look at was the things that business taxes are levied on. They're levied on the right to do business like various kinds of franchise taxes. The purchase of inputs such as sales taxes and unemployment insurance taxes are taxes on input used by business. Taxes on assets (property taxes, corporation license taxes), net income taxes (which you already mentioned), taxes to cope with external costs—they used to call them “sin taxes,” taxes on alcohol, tobacco, things that are thought to do damage—and finally, taxes on the depletion of nonrenewable resources like our coal severance tax are how we tax business in a variety of ways. We justify them by the ability to pay, which was mentioned in the early session. We think businesses can afford it. Hey, they're big corporations; you know they can pay. We also justify by tax exporting. The notion is some taxes, like a coal severance tax, can be exported because the coal is sold in more than one place, and it has to be mined where it is. There's some thought that some of the business taxes that are borne by the owners of the business are exported because the rich stockholders don't all live in Kentucky, so some of them are effectively paying some of our taxes. Bob mentioned political expediency. It's always popular to say we're going to tax business, you know, rather than the digital and then there's the benefits principle. There's an argument by some economists that we should only tax businesses for the public services provided to business. By having set business taxes in addition to that, we fool people into thinking that “the business community” is paying for some of their public services and, therefore, citizens may prefer a higher level of public services than they would if they felt they were paying for all of it by themselves. That's an argument that's been made, but it hasn't really been persuasive.

Most of the studies, including the one done by Mr. Cox, show that business tax levels everywhere are higher than would be necessary to simply pay for the public services provided to business. I began by reviewing a number of earlier studies of business taxation in Kentucky. One of the earliest is a study by Wheaton done back in the early 1980s for tax year 1977. He looked at corporate income taxes, unemployment insurance, severance, license, and property tax, insurance premiums, and a whole lot of business taxes and developed a measure of business income in all the states. That study found that Kentucky was a very low business-taxed state. We ranked 43rd in the nation in the Wheaton study.

Some years later, the Advisory Commission on Intergovernmental Relations, the ACIR, did a number of studies for several years in which they measured what they called “tax capacity” and “tax effort” for a number of different taxes in every state. Now the tax capacity is what they would measure—the tax bases in the state for a number of widely used taxes. Retail sales would be the base for your sales and use tax. Personal income would be the base for your income tax. They then computed on a per capita basis and applied the average tax rate across the whole United States to each state, and the result was your tax capacity for that tax. For example, if you have 80 percent of the sales per capita of the average state, then your tax capacity is 80 percent of average. In the last study the ACIR did in 1991, Kentucky had a tax capacity index of 83 percent, as we had 83 percent of the average ability to tax. Then they measured tax effort, which simply compares the revenue per capita generated for each tax to the capacity. So even if we don't generate as much revenue per capita as the average state, if we generate more than we should, based on our

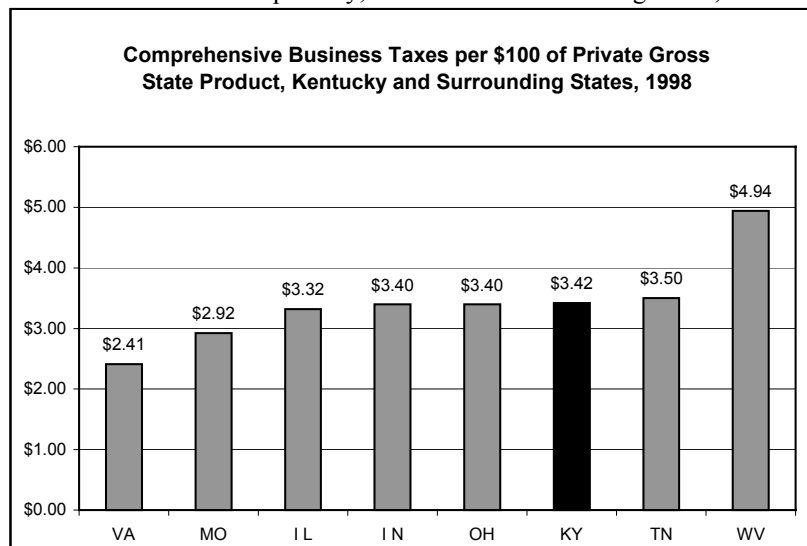
capacity, then we would have an above-average effort. Our effort was exactly 100 for all taxes combined in 1991. It's particularly high for income taxes, very low for property taxes, and somewhere else on the other taxes. And of course, a tax effort of 100 didn't mean we were average and it didn't mean we were the median state, either, because there are only 16 states that were 100 or above, so we were still in the top group there. But remember that 1991 was right after we increased taxes substantially to pay for KERA, so that was a year that would make us look particularly bad, because after that our taxes have not grown the same way that other taxes have.

The Barents Study was done in 1999, and what the Barents Study did was look at creative representative firms in 19 industries and by representative, I mean they used national data from the IRS and what an average corporation's sales should be, their size should be, their investment, their payroll and various costs, and they did this for 19 industries. They located these hypothetical firms in average local property tax areas in the surrounding states and most of the other southeastern states. The states are competitive with Kentucky and, I think, Michigan was included, too. Then they computed the corporation income tax, the corporation franchisee tax, property tax, and sales tax on inputs. Kentucky was basically average and in some industries perhaps a little above and some a little below, but we came out average, again using just these broad measures of taxes. They also measured household tax burdens at different income levels, different family sizes, and found we were pretty high in personal taxes compared to these states, except at the lowest level where we were about average with these states.

Then a study done by the Center for Business and Economic Research at the University of Kentucky and the University of Louisville College of Business and Public Administration (UK-UL) took the approach of trying to add up all business taxes collected and then divided them by a broad tax base. The base they chose to use was private earnings, basically wages and salaries, proprietors' income, and other labor income fringe benefits. They included corporation income, business license, severance taxes, utility, property, unemployment, and workers' compensation, and when they looked at state and local taxes, we were 8.4 percent above average. I looked at these studies critically.

In the Barents Study, one thing that I guess all tax studies do, including mine, is they don't look at anything but taxes. You can have these hypothetical corporations but you're not considering any other cost differences. Is labor cheaper in Tennessee? Is energy cheaper in Kentucky? You don't look at that. You assume that all their costs are the same except taxes so that you can focus on the impact of taxes. You don't consider public service. After all, some of the highest tax states in the country don't seem to have trouble attracting business because presumably their level of public services is high. But these kinds of studies, again, including my own, don't look at that. They ignored rather sophisticated tax shifting and avoidance techniques, they looked at kinds of incentive programs that were generally available, but not all the ones that were specifically available.

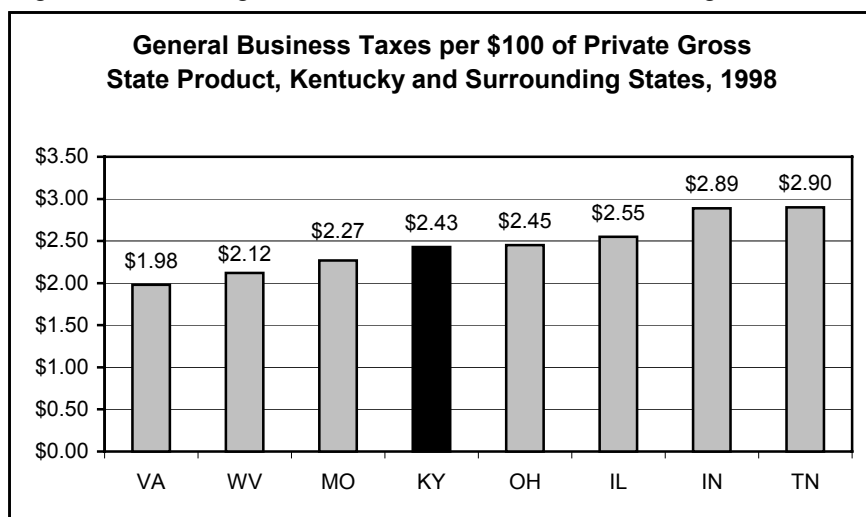
The UK-UL study used private earnings, which is strange as a tax base, because private earnings are pretty low in Kentucky relative to total personal income and most studies would use something like total personal income. It's the only study that I've ever seen that used private earnings, and it seemed like a peculiar choice for a tax base. They considered state taxes separately, which is not a fair thing to do, because Kentucky is very centralized; we raise



about three quarters of our revenue at the state level, one quarter at the local level. Most other states raise relatively more at the local level. So if you only look at state taxes, we're always going to look bad. They didn't include any sales taxes on inputs, and there are sources available to get that information. They did include unemployment and workers' compensation, which are not often considered to be general business taxes, particularly workers' compensation, which is not so much geographically specific as industry specific. If you've got industries like coal mining, you're going to have pretty high workers' compensation costs. Of course, like the other studies, they also ignored nontax costs and public services. If we look at our share of tax revenue, state versus local, you'd think Kentucky is 76 percent, and the only other state that high is West



Virginia, 76.2 percent. All the other surrounding states, which is the group that the UK-UL study compared, have much lower shares. Also, if you look at private earnings as a percent of total personal income, Kentucky is very low. Virginia and West Virginia are lower but all the other states are higher.

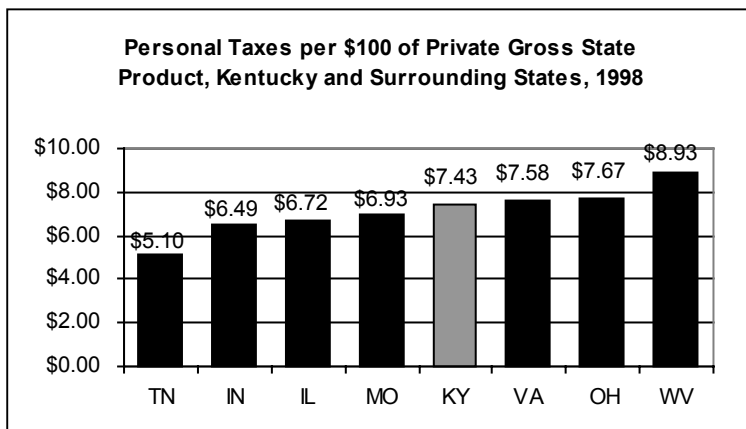


My suggestion was the gross state product (GSP) would be a better measure and particularly private GSP. By definition, GSP is the value added by all the businesses in the state, particularly private GSP, then you can add the government to that. GSP is the total sale minus everything you purchased from other businesses. It's what you have available to pay for wages, interest, rent, profits, and taxes. You can see that the ratio of private GSP to the total GSP is much more clustered than it is with private earnings. Kentucky is 86.6 percent, Illinois 90

percent, and so forth. There isn't nearly as much disparity so it seems like a better kind of comparison. So what I did was I divided total business taxes and I used four tax bases. Let's compare them to total personal income, private earnings (as the UK-UL study did), total GSP, and private GSP, and I compared just Kentucky and the contiguous states. I also used two measures of business taxes. One measure called general, which is used in many studies, included corporation income, corporation license, any other business license taxes, property taxes, the business share, sales taxes on input, and insurance premium taxes paid by businesses. That's the narrower measure. Then to get comprehensive, I took all the general measures and added in pari-mutuel taxes, which only applies to states with racing, severance taxes, which only apply to states with mining, unemployment insurance taxes, and workers' compensation benefits, and the results were looking something like this.

This is general business taxes per \$100—I'm just showing the results for one base, general business taxes per \$100 of private GSP in 1998 and you can see Kentucky's the red state here. It's kind of in the middle, isn't it? It's fourth from the bottom, fifth from the top. Virginia is the lowest, followed by West Virginia, just on the general business taxes, then Missouri. Kentucky had a little under \$2.50 and the highest in that regard are Indiana and Tennessee. If we look at comprehensive business taxes per \$100, we get a slightly different picture. Kentucky's rank moves up, mainly because we have high workers' compensation benefits. I used workers' compensation benefits because the costs are tricky. Some of them are private, some of them are public. So I just used benefits, which again might not relate to the costs directly in any given year, but that's what I used. Here, of course, West Virginia came out looking pretty bad because they have very high workers' compensation benefits and very high severance taxes. Virginia was the lowest. Again, Missouri, Illinois, and Indiana, but if you notice here in the middle, there are a couple of low states and then everybody is pretty close and then you've got West Virginia being very high. From this you pretty well had to conclude that Kentucky is pretty average on business taxes.

So I took a look at personal taxes by taking all the taxes—these are both state and local, by the way—that weren't business and did the same kind of thing, personal taxes per \$100 of private GSP and again we've got Tennessee, Indiana, Illinois, Missouri, and Kentucky. And again, we're kind of high here. In fact, relative to average, we're 13 percent above average there, where with our business taxes, we're anywhere from between 99 percent and maybe 103 percent. But for personal taxes, we're well above the average of all of the states. What I concluded from this was that our personal taxes are kind of high, but on the other hand, as we saw from the ACIR study, our tax capacity is kind of low. So if we want to have average public services, we're going to have to tax somebody high, but who we tax high seems to be more household individuals than businesses.



Again, remember that businesses are able to shift some of their taxes backward to labor and other input suppliers, some of the taxes forward to customers, and some of the taxes are borne by the owners of the business. As Bob indicated, we don't really know what that shifting is. But again, just at the competitive level, just comparing taxes levied in the first round on business with our surrounding states, we're about average and if any of our taxes are high, it's our state taxes. Well, I see, I've come to the last slide, so I guess I'm done. I'll be happy to take any questions of anybody. Yes?

QUESTIONS, ANSWERS, AND COMMENTS

Questioner

Populations figure in some of the analyses done. Will Kentucky have less population? We don't fare as well in comparison.

Dr. Lynch

I did not take total population into account. You would have to argue that there are some public services that have high fixed costs regardless of population. I mean, if you're building a through highway, then that would be financed mostly by the federal government, anyway. But you have to argue that there are some services that are independent of population or some minimum level that's independent. Do you have an idea what that might be? I was just wondering. I mean, it could be.

Questioner

The costs between number of people, of course the less people...

Dr. Lynch

Yeah. I used income type measures as a base. You could use some per capita bases, but the income, or some measure of income, output production, is a better measure of tax paying capacity than simple population.

Questioner *(inaudible question)*

Dr. Lynch

Yeah. That question had to do with do we consider population? Any kind of per capita measures taxation, and the answer was no. Instead of per capita, we used per dollar of income, output production. Other questions? Yes.

Questioner *(inaudible question)*

Dr. Lynch

The question is, "What were the states with which we compared Kentucky, the states with which we compete for economic development?" The Barents Study used a broader measure. They used the southeast, the surrounding states of the southeast, and I think they might have thrown in Michigan—due to autos and auto parts. I simply used surrounding states. I was limited in the time that I had to do the study, which is why I just used the surrounding states. But again, I don't think the fact that the Barents Study used some additional southeastern states would have made that much of a difference. They do have some state-by-state results in their report.

Mr. Cox

The Barents analysis was done on states that the Economic Development Cabinet requested. We asked them what states they felt we compete with the most for economic development and those were the states they came back with. In the Barents Study there are about 17 states, all the contiguous states, most of the southeastern states, Michigan, Arkansas, maybe Alabama, Mississippi, Georgia, the Carolinas.

Questioner *(inaudible questions in the background)*

Mr. Cox

I really don't have an answer to those questions. I think you raise some interesting points in that maybe perhaps we haven't focused on the areas of the new economy. One of the things that I think was a deliberate policy, maybe about 10 years ago, was the issue of so-called good jobs. Manufacturing jobs were held out to be good jobs, and the bad jobs were the service sector hamburger-flipping, low-pay jobs. We may want to reconsider this strategy of picking which industry you think you want to focus on and ignoring other industries, or perhaps, failing to give them

their proper consideration. Because in this case, I think Kentucky is very heavily invested in manufacturing. We're primarily a manufacturing state, and some people have pointed out that we are behind in the so-called "new economy" industries, and I think it bears some more looking into. That's all I can say.

Dr. Lynch

The specific states that were used in the Barents Study at the request of the Economic Development Cabinet were the seven contiguous states plus all the southeastern states except for Florida and Louisiana, plus Michigan. Yes?

Questioner

What are your conclusions of your study and what is your recommendation?

Dr. Lynch

OK. I was asked about the conclusions of the study and the recommendations. The basic conclusion is our business taxes are not out of line with the surrounding states. Therefore, as a recommendation, which we didn't make, you'd have to say that there's no overwhelming need to reduce business taxes or to increase them, for that matter. But there may need to be some realignment of business taxes. There are areas perhaps at the microlevel where we could reduce some taxes, increase some others. It was mentioned that the LLC corporations are perhaps not paying their fair share or a share that might be termed fair by someone who's not part of an LLC corporation. But there may be specific changes that could be enacted that would help us in competitiveness, but at the overall level, there doesn't seem to be any great need to reduce or increase the overall level of business taxes. That would be the conclusion. Yes, in the back.

Questioner (*inaudible question*)

Dr. Lynch

By looking at two different groups for taxes, the general taxes I looked at didn't count the severance tax or anything like that. It just looked at business license taxes, corporation income taxes, property taxes, and sales taxes on input, those basic kinds of taxes which would apply pretty well to all industries, and we were average in that regard. Yes, sir?

Questioner

I think, though, if you compared yourself to the most successful high-income state, we'd find we had pretty low taxes compared to those states. Look at New England and California.

Mr. Cox

Can I interject something? I think there's something to that, but then you can always look at the flip side. Right now we're thanking ourselves that we didn't do like California when they deregulated their electric utility and they're certainly one of the states that is the most prosperous. So yeah, you might want to look at them but sometimes you might want to look at them in order to avoid their mistakes.

Questioner (*inaudible question*)

Dr. Lynch

Bob did a study where he tried to measure the public service that provided the business, but did not do a study of private provision versus public provision of specific services, as I recall.

Mr. Cox

You get into a lot of controversy when you do this with your colleagues as to what is a "business service." The work that I did, for example, looked at state spending on education and said, "that is all a benefit to individuals and not to businesses." I received a fair amount of criticism over that, although I still will probably contend that in a free job market where people are free to choose which job they're going to go to, their wages are going to be bid up to their level of productivity. That's the way the job market is organized and it's one of the most competitive markets in the economy. So if there are any sort of profits extracted by underpaying your workers for their educational value, it's kind of hard to make that argument in my mind. Although, I will say there are other economists that will disagree with that.

Questioner (*inaudible question*)

Dr. Lynch

Most economists believe that specific excise taxes on things like alcohol and tobacco are pretty well shifted forward to the user. Because the demand for those kinds of products, as we say in economics, is not price sensitive, most of the taxes are shifted to the users.

Questioner (*inaudible question*)

Dr. Lynch

A Big Mac tax. Well, we have one of the lowest cigarette taxes in the nation and for various reasons, in that we are growers of tobacco. There have been a few half-hearted attempts over the years to raise that tax and it hasn't worked. I suspect that since we can't pass a bottle bill, I don't know how we'd be able to pass a Big Mac tax.

Mr. Cox

Most economists would not consider those to be taxes borne by business, but like you said, shifted onto the individuals. So the businesses that sell those products have a natural interest in keeping the price of them low, but I would argue not that great of an interest. After all, the tobacco industry argued successfully for—how many billions of dollars was it?—the master settlement agreement, and basically paid for it by tacking on higher prices to their product. Most economists have said this is a tax increase by judicial determination. The lawyers and the judges have gotten together and decided how much more the price of cigarettes should be in order to pay the states what they say they need to get. It hasn't been passed by any legislature, but it's making a lot of money for a lot of states.

Questioner (*inaudible question*)

Mr. Cox

Well, it depends on what we call elasticity of demand for a product and if it's a product that's easily purchased at a lower price somewhere else, people will run and flock to it. For example, we always look at Tennessee and say their sales taxes are high. People come from Tennessee to Kentucky to buy groceries because there is no sales tax on groceries. The sales tax is over 8 percent on groceries in Tennessee. So people around the borders come over here to buy groceries. Certainly that's got to hurt the Tennessee businesses. Is the tax actually borne by them? In most cases we would argue that their business community, those grocery stores, have contracted to a level where they're profitable now. So in theory, you'd say they're probably not suffering anything from that taxation although they could probably benefit if we threw a tax on groceries, because they would expand and grow and their profit level would be higher. Yes, ma'am?

Questioner (*inaudible question*)

Dr. Lynch

If I understand your question, you're saying, presumably if you raised the tax, you would help—by discouraging the activity—lower other costs?

Questioner (*inaudible question*)

Dr. Lynch

I'm not aware of it. I do know that high taxes, like in Canada, have discouraged consumption, which is one of the aims.

Mr. Cox

Actually, I think there are models called "general equilibrium models" that would look at something like that and look at, if you change one sector of the economy, how that feeds through all the other sectors. These things are very expensive to build and they don't give you very good answers. Basically what you look for from them is whether you're going to have a positive or a negative impact, and, if you're lucky, you'll get the sign right, but coming up with actual magnitudes is probably beyond the state-of-the-art right now. We've got time for one more question and then we'd better break for lunch. So who wants to go last? Nobody. Nobody wants to stand between us and lunch? OK.

Dr. Lynch

Thank you, everybody.

WHAT IS THE TAX BURDEN ON KENTUCKY'S FAMILIES AND IS THE BURDEN DISTRIBUTED FAIRLY?

Moderator

Mary Lassiter, Deputy Executive Director of the Governor's Office for Policy Research

Presenter

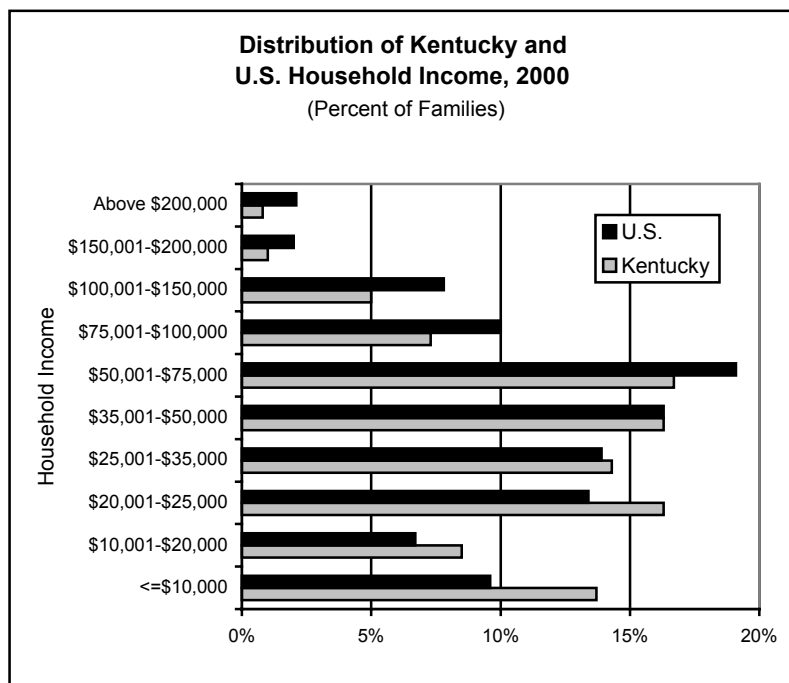
Dr. Charles Martie, Research Analyst in the Governor's Office for Policy Research

Ms. Lassiter

Good morning. May I have your attention, please? I guess I could say this is kind of like church. We filled up from the back first. There's still a few seats in the front row, although my mother told me never to sit too close to the TV, it was bad for my eyes. So if you do sit up close to the front, you're going to be staring right at the screen. We'll give folks a couple of more minutes to get seated. My name is Mary Lassiter. I'm Deputy Executive Director of the Governor's Office for Policy Research and that's within the Office of the State Budget Director, but I'm not here in that capacity today. I'm a Board Member of the Kentucky Long-Term Policy Research Center and I'm proud of that position. The Center's very proud of the attendance today and the interest in this topic. Mike Childress talked this morning in terms of chapters and that the Center's work over the last year has focused on tax equity, tax adequacy, the principles of a good tax system. And he said that the chapters that we've been working on will be posted on the website today, I guess as a teaser to entice you to go look at those chapters on the website. The book will be published in written form, but just to highlight for you what some of the different topics are, there's a chapter on recent trends in local and state policy; sales taxation; tax equity, what we're going to talk about today; business taxes; local government finances; the impetus for tax modernization, and that seems to be the word of the day, modernization; and a section, or chapter, on tax reform review and perspectives, similar to what Dr. Hackbart talked about earlier. Tax equity, and it's all in the eye of the beholder, produced a very good discussion this morning from a lot of different perspectives about what is equity. Dr. Wildasin talked a little bit about horizontal and vertical equity. Jim Ramsey focused for us, and reminded us, that a big issue in the 2000 Session of the General Assembly was on equity for low-income Kentuckians. Is our system of income taxation fair for low-income Kentuckians? That was an issue. When we talk about the principles of a good system, equity is right there at the top of the list. Is the system equitable, is it adequate, is it competitive, is it simple or easy to administer? But I would propose to you that fairness or equity is in the eye of the beholder. It depends on which lens that you're looking through. Representative Moberly just told us that if you just focus in on the income tax itself, studies have shown that maybe our income taxes are too high on the working poor, on low-income people. But if you look at the overall perspective of all taxes, what does that burden look like? Maybe it's a different perspective, a different view through a different lens. So that's what we're here to talk about this morning. Dr. Charles Martie has written the chapter entitled "Tax Equity in Kentucky: Family Burdens and the Question of Fairness." That's Chapter 4 if you go to the website. Dr. Martie is a Research Analyst in the Governor's Office for Policy Research, so I'm very proud of that. Prior to that, he was Director of Research at the Kentucky Revenue Cabinet. He did work in that capacity and does work in this current capacity on tax policy, data warehousing, and the application of data mining techniques to tax compliance. He was formerly an Associate Professor and Chair of the Economics Department at Quinnipiac University in Hamden, Connecticut, and he has also served as an economist in the Bureau of Economics at the Federal Trade Commission. So Dr. Martie, the floor is yours. We will have Dr. Martie's presentation and then, hopefully, we'll have some time for questions. Thank you.

Dr. Martie

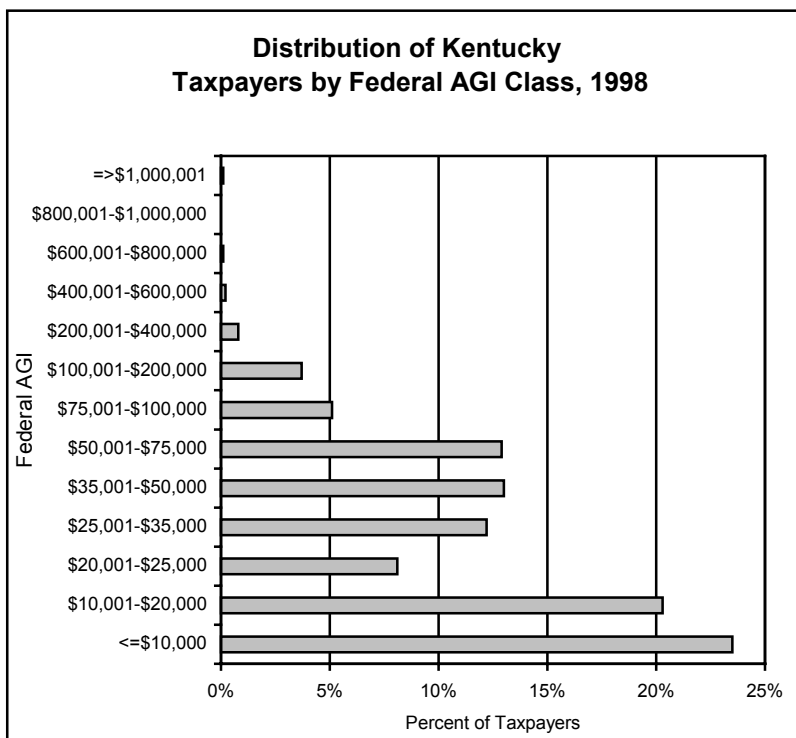
Thanks, Mary. What I don't want to do this morning is begin to think that I could tell you what is fair and what is not fair, particularly about something as sensitive and complex as Kentucky's taxes. But I do want to take a look at what studies have found and what implications arise from those studies. I do want to borrow from Fran Liebowitz's quote when she was talking about Algebra and she said, "Stand firm in your refusal to remain conscious during economics. I assure you there's no such thing in the real world as economics."



Today I do want to discuss some of the definitions of equity that might help us focus on what the issues are in Kentucky. In the interest of time, I'll just briefly go through some of the data that describes Kentucky. First of all, Kentucky is a relatively poor state, and we have a median household income of about \$32,000, and that's about fifth lowest in the country. This chart compares us to the U.S. The light line is Kentucky, and the dark line is the U.S., and as you can see, we're bottom heavy. In fact, if you wanted to make Kentucky look like the average state, you would have to lift 140,000 households over the \$25,000 income mark at the low end. If you wanted the high end to look like Kentucky, you have to move 83,000 families over the \$100,000 mark. So essentially we have a very skewed income distribution and a very low mean and median. If you think of the middle class as being

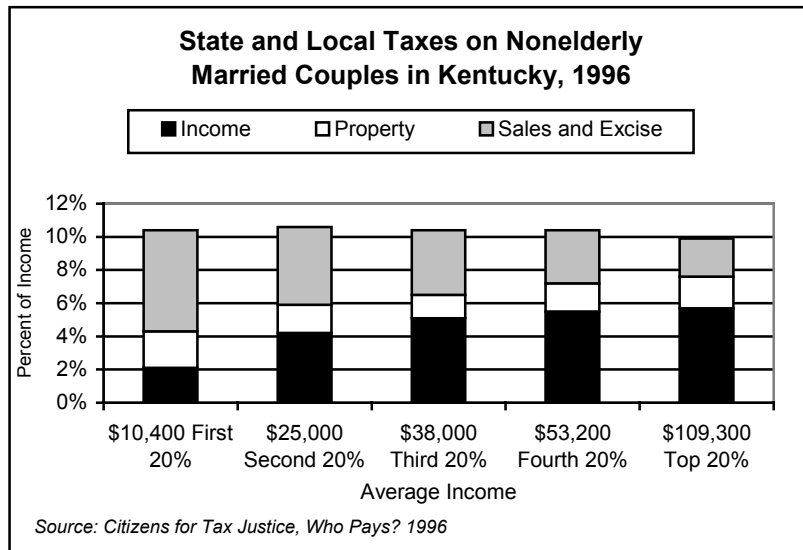
somewhere between \$35,000 and \$75,000, Kentucky is missing 37,000 families in that class relative to the average U.S. state. So we're not starting out from a position that allows much flexibility in terms of fairness for state and local tax policy.

There are only a few instruments that state and local governments have in their arsenal to tax a population like shown in this chart. If you look at our income taxpayers, this shows the distribution of Kentucky taxpayers by federal AGI class and the thing that stands out is that effectively half of Kentucky income taxpayers have an adjusted gross income of less than \$25,000. This implies—as you can see, it's very bottom heavy and there's not much at the top—that, if you wanted to do some tax reform, if you wanted to just give \$100 to everyone below that \$25,000 mark, you'd have to take it from somewhere. If you take it from families with above \$100,000 or more, you're talking about a tax increase on them of \$1,400. If you take it from the people over \$200,000, you're talking about an increase of their tax liability of \$6,000. In Kentucky, because of the distribution of income, it's expensive to do redistribution through the tax schedule.



What I did in the paper was to take a look at a couple of studies that had been done. This is one that the Commonwealth commissioned from the Barents Group, which is a group of economic consultants, and we asked them to do a household study on how the burden of Kentucky taxes looked across different households of differing income. When you look at this, this is broken up into excise tax, sales tax, property tax, and income tax, and the bottom one is the only one that has some progressivity in there. That is the income tax, of course. But if you look at it overall, it essentially says that no matter where you are in the Kentucky income distribution, you pay about 8 percent of your income in Kentucky's state and local taxes. Not exactly, though, and one thing you notice, too, is it's regressive at the high end. That is, once you get up to \$150,000 in income, your effective tax rate is slightly lower than that of people in the middle class and that's true as well for people earning \$200,000. The question this begs is, so what? How do we as a society feel about proportionality?

If you look at the federal taxes, which these same people pay, the federal tax system is very progressive, with effective rates rising from 7 percent for that poor family to over 25 percent for that upper-income family. So how do



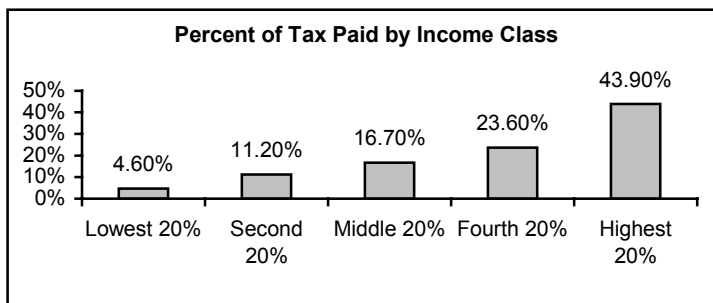
we in this federalist system want to position ourselves? Is it OK that we get enough progressivity at the federal level or can we do more?

I also looked at another study by Citizens for Tax Justice. It was done in 1996, so it doesn't have some of the recent changes. It doesn't have pension income, but they focused on nonelderly married couples, so that's not a big problem. Probably the biggest thing it doesn't have in there is the effect of the St. Ledger decision on intangibles. So the burden on the high income is probably actually a little high and given their definition of income, essentially we find the same thing, that we have a roughly proportional tax system in Kentucky. The dark boxes are income.

We've got a somewhat progressive income tax, and our sales and excise taxes are pretty much as you would expect. They are fairly regressive. But the combination of those things is that they use a different measure of income. They say out of this income, Kentuckians pay 10 percent of their income in tax, no matter how much they earn. So that sounds pretty benign.

But here's the exact same data expressed a different way. The dark line is the percent of income earned by that fifth of families. These are broken out into the lowest-income fifth of families, the second lowest, the third lowest, and so on. The white bar next to it is the percentage of taxes.

In a purely proportional tax system, the black and the white box would be equal. That is, if a quintile earned 5 percent of the income, it would pay 5 percent of the taxes. So one thing we're seeing here is a reflection of mostly proportionality, except at the very high end. So you see that the highest income quintile earns 46



percent of income, but they pay about 44 percent in taxes. But the other thing you can look at, there's the same number of families in each of these quintiles. So what that means is that in the highest income 20 percent, each family pays as much on average as 10 families from the lowest income group. A slightly different inter-pretation of

How Kentucky Ranks in the United States Based on the Citizens for Tax Justice Study				
Income Quintile	General Sales Tax	Total Property Taxes	Personal Income Tax	Total Taxes
Lowest 20%	30	46	11	37
Second 20%	32	40	5	13
Middle 20%	32	39	5	12
Fourth 20%	30	36	5	8
Next 15%	30	32	4	9
Next 4%	29	30	8	12
Top 1%	14	39	16	20

Source: Citizens for Tax Justice, 1996

that again begs the question, how much of the burden? Another way of looking at it is that the top two income quintiles pay about 67 percent of Kentucky state and local taxes. The lowest income quintile pays about a little over 4 percent of taxes. So it's just another way of looking at the same data.

The question that a lot of legislators like to ask is, how are we doing relative to other states? No state wants to stand out in terms of its taxes. And so if you look at The Citizens for Tax Justice study, which was across all taxes and all states, and the same income quintiles, if you look at the lowest 20 percent, it shows we're 11th highest on personal income tax. But if you combine our sales tax that has significant exemptions for necessities and a kind of low reliance relative to the rest of the country on property taxes, overall, we come out pretty good. Overall, we're 37th highest in the nation, or 14th lowest.

One thing you should know about that low-income group—and Senator Sanders talked about the Mike Clark study from LRC that found that for low-income families, Kentucky has a fairly low burden and this shows the same thing—there are families in this income quintile that earn on average about \$10,000, but below \$10,000 the low-income credit takes away most of the income tax burden, and the sales tax burden exemptions on necessities take away a lot of the sales tax burden. But if you're looking at the working poor, if you're looking at what is commonly focused on, the income interval between \$15,000 and maybe \$25,000, that second income quintile and, if you notice, there's a big jump. We become the fifth highest personal income tax burden in the country, not much change in sales and property taxes, but overall we jump to 13th highest. This, in great part, reflects some inattention to the income tax that essentially had to be corrected before with the low-income credit, but once you get above \$15,000 the low-income credit drops off to very low levels. So I thought I would investigate that. I thought I would take a look. The Barents Study shows the same rankings: at poverty level, we're fairly in the middle, but above that we have a relatively high tax burden compared to income.

So I wanted to take a look at how the income tax got this way. The theory that I had was that we tend to blame tax policy on legislators and governors, but they're not the only culprits. The taxation without representation is tyranny and taxation with representation is worse. But there are some other culprits out there. There are other entities that make tax policy. One is the courts, and I've mentioned the St. Ledger decision, which altered the equity of our property tax system. Later on we'll talk about the Humana decision, which affected the treatment of prescription drugs in hospitals, and the economy affects equity. One thing we'll talk about here is how inflation has robbed the income tax of most of its progressivity, but also taxpayers. Taxpayers themselves determine tax policy. The best example of that is the almost pervasive evasion of consumer use tax that has become quite popular. People have taken it on their own not to abide by that statute.

Anyway, what I did here was take a look at the current law as it stands and take the law back to the year that it was initiated and add inflation to it. So if you see the tax rate brackets, those were instituted in 1950, and the 2

Kentucky's Income Tax: Current Law (2000) vs. Indexed			
		Current Law	Indexed Law*
Tax Rate Brackets	Rate	Taxable Income Range	
	2%	\$0-\$3,000	\$0-\$21,422
	3%	\$3,001-\$4,000	\$21,423-\$28,563
	4%	\$4,001-\$5,000	\$28,564-\$35,704
	5%	\$5,001-\$8,000	\$35,705-\$57,126
	6%	over \$8,000	over \$57,126
Low-Income Tax Brackets	Rate	AGI Range	
	100%	\$0-\$5,000	\$0-\$6,595
	50%	\$5,001-\$10,000	\$6,596-\$13,190
	25%	\$10,001-\$15,000	\$13,191-\$19,786
	15%	\$15,001-\$20,000	\$19,787-\$26,381
	5%	\$20,001-\$25,000	\$26,382-\$32,976
	0%	over \$25,000	over \$32,976
Standard Deduction		\$1,700	\$4,419
Personal Credits		\$20	\$115
*This is a hypothetical law. If the tax rates were indexed to the Consumer Price Index (CPI), these would be the resulting income ranges associated with each tax rate.			

would also be higher. In fact, the low-income bracket would reach up to about \$33,000 and give some tax relief there. To me, there's some big differences in the standard deduction, although in the last couple of years we have indexed it, but we didn't index it enough to catch up for all those years they didn't do sufficient indexing. And if we had indexed it, the standard deduction would now be \$4,400 instead of \$1,700 and the personal credits were \$20, to essentially take care of children and other expenses and exempt that expenditure from taxation. It was \$20 back in the 1950s and it's still \$20. If we had indexed that, a family of four would be getting an income tax credit of \$460, instead of \$80. So suppose we had done that. Well, it creates a problem when you bump up all those income tax brackets and you raise the standard deduction and you add those credits, you lose a lot of revenue. In fact, if you just do the model straight and apply that indexed law to the current income, you lose about \$1.2 billion. You essentially gut the income tax.

percent rate applies to taxable income from zero to \$3,000. If you indexed that to inflation; that is, if we had created the law back in 1950 that says, "We're going to adjust these brackets like the federal government did to inflation," people earning from zero to \$21,000 now would be facing a 2 percent rate. In fact, our 6 percent rate wouldn't kick in until \$57,000 instead of \$8,000. Our low-income tax brackets, initiated in 1990,

So it's not likely that legislatures and the Governor would have allowed that to happen, so what I did was say, suppose we indexed, but replaced the lost money with just a proportional tax perhaps like local occupation taxes or some mixture of state and local taxes that, as we've seen from previous charts, are proportional. Here's what happens to the per-household tax burden. People in the lowest income class, from zero to \$10,000, currently pay about \$30. If you indexed and made up the money with a proportional tax, they'd actually be worse off. Because those proportional taxes tend not to come with exemptions, or I'm talking about raising the property tax or raising the sales tax, so the poor actually do a little worse off.

Effect of Revenue Neutral Indexing by Income Class			
	Per Capita Tax (\$)		
AGI Class	Current	Indexed	Difference
\$0-\$10,000	30	80	50
10,000 to 20,000	430	309	-121
20,000 to 30,000	1,007	642	-365
30,000 to 50,000	1,654	1,201	-453
50,000 to 75,000	2,672	2,218	-454
75,000 to 100,000	3,807	3,517	-291
100,000 to 200,000	5,792	6,187	396
Above 200,000	21,114	33,008	11,894
Total	1,729	1,729	0

Source: GOEA microsimulation model calculations

It reflects the fact that, at those low-income ranges, Kentucky's done a pretty good job of insulating the poor from the burden, as the LRC study showed. But, then you get up to the \$10-20,000 range, and if we had replaced the current law with an index law and a proportional tax, you see that it starts to benefit the working class. In fact, you have to get up to between \$100,000 and \$200,000 before it becomes a burden. And then above that, you see it becomes a substantial burden. Now a way to turn this around is to say that the failure to index the income tax has been a boon to wealthier families in the state. This is just a reflection of the lost progressivity. Even though there hasn't been a lot of inflation, these are very old laws on the books and they have failed to, I hate to overuse the word, modernize along with the economy. So a lot of the blame for the income tax problem and the burden on the working poor has to do with inflation.

There are some survey studies that have shown that most people don't know how much they pay in taxes. So all these average burden studies suggest that people know what their average burden is and to care about fairness. You almost have to say, well, I not only know what my average burden is, but I know what yours is, and what yours is, and that's not fair. But a lot of surveys have found that people tend to, on a two-to-one basis, overestimate their tax burden and most can't even estimate it within 10 percent of the true burden. So I got less enamored with studies of average burden. I started thinking about how the government treats people on the margin, and being an economist, we like to focus on things on the margin. That is, suppose I was a poor family making \$15,000 and I got offered the opportunity to earn \$1,000 more, how would Kentucky treat me? Well, not very well. The marginal tax rate, if I'm at \$15,000 going to \$16,000, is about 11 percent. Why? Because I move into a higher bracket for the low-income tax credit, and that drives my credit down so I only get to keep \$890. Compare that to someone who's income is already \$200,000. On the margin, they only get hit with a 6 percent tax. If you couple this kind of thinking with what we do on the benefit side, the marginal benefit reduction rates for Medicaid, food stamps, and housing subsidies are significant and substantial. There was a study done by HUD on just taking a look at a Pennsylvania family, a working mother with two children, that found the marginal tax rates and marginal benefit reduction rates faced by that family were somewhere around 82 percent. So to me, when we start thinking about tax equity, we ought to think a bit on the margin, how we affect people's decisions to work, save, and invest. The other thing, too, is this is purely a critter of the failure to index. In 1990 we had to adopt a low-income tax credit to remove some of the burden on the poor, but if we had indexed all along we wouldn't have had to do that and we wouldn't have created marginal tax rates. You see on someone earning \$20,000 and going to \$21,000 over 14 percent, and to me, it's a better indicator of inequity than looking at average taxes.

Just quickly on the digital divide, let's discuss how the wealthy have more access to the Internet and, therefore, more ability to break the law, and evade use tax. It turns out, since the big basis for the loss of use taxes is business-to-business, this is more of a business tax issue and, therefore, it clouds the burden of the taxes, because it may well be that poor people as well as rich people shop at companies that evade their use tax liabilities. It really muddies the water, but in terms of dollars, this is again more of an efficiency and compliance issue to me than it is an equity issue.

I ought to just finish up here with some conclusions. I didn't get to horizontal equity, but essentially the story on horizontal equity is, if you have a narrow base of high rates, you increase not only the opportunities but the extent of the inequities across people of equal ability to pay. Essentially we're a poor state with a skewed income distribution, and therefore we face a challenge in raising revenue in equitable fashion. Our taxes are proportional except at the top. We rank high for most income classes. Inflation has reduced our progressivity. Not much of a digital divide in our exemptions on the horizontal equity hinder efficiency inequity. In the few minutes remaining, I'll open it up to questions.

Questions, Answers, and Comments

Questioner (*inaudible question*)

Dr. Martie

The question is about, in those average burden tables, the hump in the middle. It seems like the effective rate on the middle class is higher at the high end than at the low end. To me that is a pure reflection of the income tax that kicks in essentially after \$8,000 for the 6 percent rate and a low-income credit that drops off to nothing after \$25,000, so there's nothing really to shield the middle class with the exception of those that itemize from the income tax. Also, you've got a group there that the exemptions on the sales tax don't benefit as much as people at the low income end. The exemption of food isn't as large a part of a middle class person's budget as it is a poor person's budget, so they're not insulated from a lot of the sales tax. Consumption and property ownership does not rise and lock step with income. So just looking at some data on the motor vehicle property tax what you find is that it's a fairly regressive tax, not because of the tax but because as peoples' incomes grow, they don't spend an equal proportion on automobiles. It doesn't rise in lock step with their income. So that's how I'd argue with that. Essentially we haven't insulated the middle-class family and even the working-class poor family from our taxes.

Questioner

I think the point you made there about what we do to people on the margins is really crucial. My experience is in working with the working poor. Of course, we have the full results of welfare reform taking effect now—punishing people. As we look at tax policy combined with our other policies related to benefits, we in fact punish people for trying to do the things that we think we want them to do. I can give you example after example of single mothers and others who've gone and tried to get an education, who moved out and tried to get a job. They are confronted with situations in which, if they took the increased tax burden and the loss of health benefits, let's say for their children, they must make a rational decision: Should I quit the job and go back? Because as a responsible parent, even though I would love to pursue my job, I can't do that at the expense of the overall economic well-being of my family and health of my children. We have that situation set up. I think the data reinforces that and so we have a system that discourages the very behaviors that we want to encourage.

Dr. Martie

That is where the true inequity lies. How does the government and its various policies affect your opportunities? You know this is the land of opportunity and yet when I teach Public Finance and we talk about marginal tax rates, students tend to think that the rich face the highest marginal tax rate, but it's not even close. If you include a marginal benefit reduction rate, which to me is wholly analogous to a marginal tax rate, the poor by far face the greatest hindrances to expansion of work effort.

Questioner

Have you looked at the distribution by race and gender? Because simply looking at it by families obscures the skewed gender and racialized distribution of income.

Dr. Martie

No. I haven't. Only to the extent that gender and race are reflected in household income. But, no, in fact I didn't get a chance to talk about it, but these burden studies are really tricky. It's very difficult to decide what definition of income you should use. The census has 14 different definitions of income, and those are critical to the outcome. Getting the tax law from 50 states in order to compare the tax law is just amazing, so I was fairly lucky to have this to work on. But that's certainly something we need to look at in the future.

Questioner

You've already decided on the definition of income for the purposes of looking at the overall family tax burden. Is there a reason why you can't use that same definition of income to break down the distribution by gender and race? Because we've done that in Tennessee and we have found a significant impact by gender and race. In other words, the overwhelming majority of women fall below \$50,000, even when you take marital status into account and, therefore, they're really burdened heavily by that.

Dr. Martie

Well, you know the short answer is, I didn't look at that.

Questioner

I'm Ron Crouch from the Kentucky State Data Center. What we're showing is basically between 2010 and 2030 all growth in the state of Kentucky will be age 65 and over because when the boomers retire, there will be a large group moving up there. But another tax and equity issue we're going to have is working poor elderly. We're also going to have middle-class and upper class elderly who get basically a big part of their state income tax free because their pension is not taxed, but the working poor elderly will be paying full taxes on their working earnings. So there's going to be a greater burden on the elderly, a big disparity between the poor and the middle and upper income.

Dr. Martie

I struggled with the issue of the pension income exclusion because, if you're comparing a younger family with an older family, you're not holding anything constant. Even if they're earning the same income, they don't have the same future income possibilities and that pension exclusion is available to the younger household. It's just not yet. So there's the difference in the tax burden; it becomes one of present value. The present value of that exclusion exemption is not as high for me as someone who's in retirement or closer to retirement, so clearly the more you carve out exemptions for people, you exacerbate the horizontal equity problem. To me, you're also talking about a severe revenue adequacy problem.

Mr. Crouch

Actually the young people are benefiting from an exemption because when I pay my pension, when I put in my pension, my 401K, it's tax free, with the understanding that, when I retire, it will be taxed. In fact, it isn't, so I'm really getting that money free.

Dr. Martie

Just an opportunity for better planning. If pensioners had known it would have been tax free, would they have saved the same amount? Would they have forgone present consumption at the same rate? Sir.

Questioner

If we had a simple percentage, whether it's decided at 5 percent or 10 percent, for everyone, without all the conditions and all the exclusions and all the exemptions and so forth, would the poor benefit from that?

Dr. Martie

I would have to say not because there's been significant effort to target tax relief to the poor and to the elderly. To me one of the most disturbing equity aspects in recent history is the increase of local occupational taxes, because those tend to be just a flat rate proportional to income and don't allow exemptions and deductions. So for a lot of poor families, I imagine their local tax burden is higher than their state tax burden.

Questioner

But I read through the press and other news media that the rich are afraid of a straight tax against them. There must be reasons because the attitude seems to be the rich get most of the breaks and the poor don't.

Dr. Martie

I don't know. Steve Forbes was the leading proponent of the flat tax. Of course, maybe that was at a time when high marginal tax rates were higher than they are now, so my guess is that, even among the very wealthy, there is a lot of variance in the tax burdens and we essentially provide opportunities for people who are willing to pay for good tax expertise and willing to attempt to risk audits versus those families that just fill out the tax returns and pay what they owe. But I think at the state level anyway, I would think there are opportunities for some progressivity in the rates. One interesting thing I talked about was if you wanted to redistribute income from the wealthy to the poor through the income tax, that you'll impose a \$6,000 burden on high-income families. But most of them will be itemized, they'll deduct that from their federal return and actually the pain won't be as great. So while it is costly, there is probably some opportunity for higher rates at the high end.

Ms. Lassiter

I think we can take time for maybe just one more question, but I know the other group sounds like they're letting out, and they'll get ahead of you in the lunch line. So if we can pass the microphone back, there's a question in the back.

Questioner

Seems that you might want to make changes to the income tax for a variety of reasons. But it does seem to me that the bottom line, until we are able to raise per capita income, is that because of the higher number of poor folks in our

state, this isn't going to do the job in raising our state revenues that we probably need to have done. Is that an accurate or inaccurate observation?

Dr. Martie

That's a good one, and I think the best thing we can do in terms of income taxes or taxes in general is to get out of the way of people's opportunities to expand their income potential. These high effective rates are taxes divided by income. Part of the story is that the reason we rank so high is just because our income is so low.

Ms. Lassiter

Thank you all. We appreciate your attendance. Enjoy the rest of the day.

Dr. Martie

Thank you very much.

WHAT ARE THE TRENDS IN LOCAL TAXATION AND WHAT DOES THE FUTURE HOLD?

Moderator

Evelyn Boone, Member of the Board, Kentucky Long-Term Policy Research Center

Presenter

Dr. David Wildasin, University of Kentucky

*Due to a delay in setting up the equipment, the audio portion of the beginning of this session was not recorded.
The following transcript begins approximately five minutes into the presentation.*

Dr. Wildasin

A critical observation about Kentucky's revenue system: if you focus on the chart comparing Kentucky with the national average, what stands out here is the relatively small reliance that Kentucky has on property taxes as part of the combined state-local revenue structure. That's been consistently true all the way back to 1977. That's not necessarily good or bad, but it's a distinction between the system of finance in Kentucky and the rest of the country. If we look at local governments alone, the thing that is perhaps most distinctive about Kentucky is our relatively heavy reliance, at the local level, on what are called income taxes or occupational taxes. We don't rely as heavily on property taxes as is typically true for local governments elsewhere in the United States. With respect to education finance, the relative importance of the state in financing schools is significantly higher in Kentucky than is true elsewhere in the country. This is not necessarily all good or bad, but a noteworthy observation.

Now let's turn to the theme, which I think is an important one: "For policy, what would be good when it comes to local government finance?" To address this issue, I think really we have to ask the question, "What do we want local governments to do from a policy viewpoint? Why do we have them and what function are they supposed to perform?" To some extent, I think some people view managing local governments as being like herding cats; they're all over the place doing all sorts of different things. They certainly are not uniform in many respects, and some of them seem to outperform others.

Some people find this disturbing. If your goal is a tidy and neat system of policymaking, local governments potentially create some difficulties. But there are advantages as well, and these are really two sides of the same coin. The fact is that all public policies have both benefits and costs, and really good policymaking, especially from the viewpoint of efficiency, requires balancing benefits and costs. This is never easy to do for any unit of government. Whether we're speaking of education or public safety or road maintenance, not all places will want to strike the balance in exactly the same way, and this is certainly true at the local government level. It's also true when we think about public policy in the country as a whole. After all, the states are diverse; they do different kinds of things. If you wanted our policies in the country to be very tidy and neat, we might need to run everything out of Washington. Or what the heck, we might as well run it out of the UN. There is a reason why we want to allow some degree of autonomy for local decisionmakers: because they are likely to make policies that are more reflective of local conditions, and this is a way of minimizing or reducing at least some of the inefficiencies in public policymaking that would otherwise arise. This is a very important potential advantage of relying on local governments to provide and finance various kinds of public services. The ways in which localities are different are extremely diverse. I can't begin to enumerate all the ways that they are different, but one important way in which localities, and for that matter, states, and for that matter, countries, are different is that some are more affluent than others. When there are differences in income, public policies are going to reflect those differences.

Now what are the potential disadvantages of letting local governments have a high degree of fiscal and policymaking autonomy? Well, I think there are two key issues. One I just touched on—the inequality issue—which arises because there are differences in the economic circumstances of different localities. Local public policies are going to reflect that and there's going to be higher quality public services in some places and lower quality public

services in other places. That's as it should be, from the viewpoint of efficient provision of public services. But that also means that the public services that are delivered by localities are going to be unequal and some people might consider that to be an important equity or fairness issue. We'll come back to that, especially when we talk about education. In addition to the fairness and equity issue, sometimes local policies have benefits or costs that don't apply solely to the people that reside within a particular jurisdiction, but affect people outside the jurisdiction. There can be what are called "spillover benefits" or "spillover costs." The policymakers in a particular locality would not necessarily take into account, in their decisionmaking, the benefits or costs that their policies create for people outside of the jurisdiction. One reason why we might want to limit the scope of local autonomy is because we want to have the interests of others that are affected by local policies be represented in the local policymaking process. That is undoubtedly the rationale for many different regulations of local policy.

Now with that as a general theme, a background, we will look at the issue of local autonomy. We start from the fact that there is diversity among localities, and there are potential efficiency gains from having policies that reflect that diversity. There are some equity issues that have to be addressed also in that context and potential efficiency arguments having to do with spillovers. That's the kind of backdrop I would generally use for considering many aspects of local government policy, including tax policy.

Let me now focus more specifically on some aspects of local taxation. The right place to start is with the local property tax, which is a principal revenue source for local governments in Kentucky, as elsewhere. One of the things that I've learned, having come recently to Kentucky, is that there's been a huge amount of controversy regarding the regulation of local property tax authority through House Bill 44. I won't belabor exactly what that law is, but essentially it's a law that limits the growth of property tax revenue at the local level to 4 percent per year, with various kinds of qualifications and exceptions. This law has been in place since 1979 and it is argued by some that this has had a significant impact on the ability of local governments to raise revenues. You could view that as a good thing or a bad thing. Maybe it is good to limit how much taxes they can collect, maybe it's bad. But I think a prior question is, "Can we see if it has actually had any effect? How would we look for such an effect?" This is actually not as easy to do as you might think. If you can remember the slide that I put up that showed that Kentucky is a low property tax state—that has been true since prior to the enactment of HB 44. Although we are a low property tax state, this is actually something that reflects conditions that existed in the state before the passage of that bill. So in aggregate terms, if we look at the combined property tax revenues flowing into all local governments in Kentucky over that period of time, you don't see any obvious impact of HB 44. That doesn't mean that it hasn't been there, but there doesn't seem to be any sort of dramatic impact on aggregate property tax collections in Kentucky as a result of the imposition of that bill at that time.

It would be nice if we could say more about this, as we now have 20 years of experience with this bill. It would be nice if somebody had collected the data on property tax revenues for all the different local governments, all the counties, all the municipalities, all the special districts, and all the school districts for the past 20 years, so we could see which ones of them seem to have been bumping up against the HB 44 limits. That hasn't been done. It's theoretically possible to do, but it would be a major data collection effort. What has been done, in the past three years, is to collect data on the growth of property tax revenues by *county* governments.

On the horizontal axis of this bar chart, in the fine print, is the revenue growth of these counties over the period 1998 to 2000. Here is the 0 percent growth bar. You can see that a lot of counties have had 0 percent property tax revenue growth over this period of time. A number of them have had 0 to 3 percent revenue growth. Here are the counties that have had 4 percent revenue growth—that's the HB 44 limit. There are a couple of counties that have had greater than 4 percent revenue growth. What does this chart tell us? It says that there are not many counties, though there are some, that seem to be up against the 4 percent revenue growth cap that HB 44 imposes on county governments. There are many counties which are not, in the last several years, operating right up against that cap. There are some that have actually cut their property tax revenues. So what does this tell us about whether HB 44 is having an effect on the financing of county governments? I think we can say that relatively few counties appear to be limited by the 4 percent cap. That is to say, the impact is not widespread, it seems, for the county governments.

That doesn't mean that HB 44 doesn't matter. It's a subtle question to figure out exactly what the effects of this cap might be. For example, one reason we may not see too many counties up against the 4 percent revenue cap is that they may be relying on other kinds of taxes. So maybe one way that local governments have responded to HB 44 is to increase their reliance on other kinds of taxes over time. I've also heard the argument made that one way to get around the HB 44 caps is to create new special districts because, when you create a new local government, it's not immediately subject to these constraints. I tried to see whether there's evidence that that's the case. Amazingly enough, it seems that there have been remarkable changes in the number of special districts in Kentucky over time, but that's also true in the country as a whole. I'm going to just read you these numbers because you can't possibly make them out from the slide. These are five year intervals from 1972 onwards and in Kentucky the number of special districts really shot up dramatically between 1972 and 1987 from less than 400 to over 1,000 special districts. So there was a huge increase in the number of special districts. But that also happened at the national level, so Kentucky was not unique in this respect. There was a big proliferation in special districts over that period of time.

Since that time, the number of special districts has come down quite a bit, to around 600 from the peak of around 1,000. During that period, at the national level as well, the number of special districts has also come down. This is a very indirect piece of evidence about whether the effect of HB 44 has led to proliferation of new governmental units. It's not a definitive analysis, but it suggests that the effects are perhaps not particularly noteworthy in Kentucky.

There is another important way that the tax limitation can affect local policymaking. I guess the idea of tax limitations is to keep taxes down. But, if you know there is going to be a cap on future revenue growth, and for a year or two you have a situation where you don't need as much tax revenue because your expenditure needs aren't too great, you might say, "I'd better keep taxes up now, for a rainy day, in case I have greater expenditures in the future." We might, therefore, see that local governments don't cut taxes as much as they might otherwise do because of their inability to raise taxes in the event of future contingencies. So there are many potentially subtle effects that this limitation can impose or can create for local decisionmaking. We don't know exactly what those effects are. Yes, sir?

Questioner

What about your data as far as urban counties versus rural counties?

Dr. Wildasin

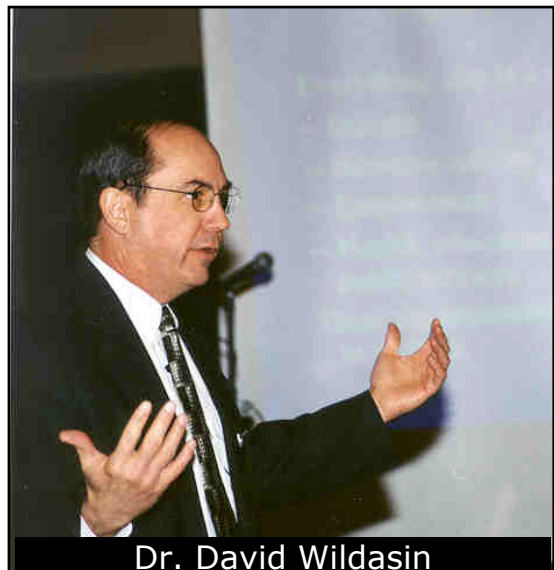
I didn't distinguish between them. I've looked at all of the counties, but didn't distinguish between the urban and the rural. One could certainly do that. I would like to defer questions, if I can, because I know I'm almost actually already out of time and I do want to talk about education issues.

Let me just say that we do rely unusually heavily on nonproperty taxes at the local level, including the occupational license tax. This is not exactly an income tax. This tax is subject to various kinds of limitations, not unlike the HB 44 limitations. For some localities, we have pretty definite restrictions on their ability to use this tax. For mid-size municipalities, there aren't such restrictions. We're very uneven in the way that we apply state restrictions to local taxing powers. In this particular case, the occupational license tax is widely used by municipalities and counties and accounts for a significant amount of revenue.

I guess I'll finish this part, before talking about education, with this general policy issue. Should local governments be deregulated with respect to rates of taxation? We have limits on property tax revenue growth, and we have limits on the rates of taxation, for some localities, that can be applied under the occupational tax. Why do we have those regulations? It certainly complicates the fiscal structure and fiscal relations between the state and local government in Kentucky. In many cases, local governments that represent mid-size municipalities—which are not limited with respect to the rates of occupational taxes—don't run these tax rates up to exorbitant levels. Probably that's because it would be a very unwise local policy, and local policymakers are not going to choose to do that. With regard to HB 44, it seems that at least some counties might be up against these limits, but many seem not to be. If they're not up against these limits, what does that tell you? It tells you that you probably don't need these limits in order to keep county governments from running away with huge tax increases. I pose that as a topic for discussion, perhaps, but I think, generally, we should be asking, "Do we need these constraints on local government policymaking?" After all, local governments are going to be constrained by local policy imperatives anyway, which I might broadly summarize as "competition."

A separate question is, "Should they be regulated as to the *types* of taxes that they can use?" And this is a more complex question. We allow local governments to tax property and we allow them to collect income taxes, and there are a variety of other revenue sources that they can use. I guess a general question always is, "What is the interest of the state in controlling the kinds of taxes that local governments have at their disposal?" These kinds of regulations can certainly have a significant impact on the mix of taxes that we use at the local level, which is an important structural issue.

Now let me talk a bit about education finance. State and local governments—and to some extent the federal government, but mostly state and local governments—are the important sources of funding for local schools. Here we show total education revenue from 1990 to 2000, the amount of education revenues that come from state sources, and the amount of revenues coming from local sources. You can see that the state government accounts for a significantly higher share of total education funding than is true of the local government. These amounts of money have been increasing over time. The relative importance of the state and local



Dr. David Wildasin

governments has also been shifting over time. Here is the same period, 1990 to 2000, and the percentage shares of financing coming from the state and local governments over this period of time. The state share in the early 1990s was around two thirds of local school finance and it has shrunk to about 55 percent. The local share has risen from about 25 percent to about the low thirties, so there's been a gradual increase in the relative share funding coming from the local governments over this period of time. It's a shared responsibility, but the balance is shifting.

We can't really talk about education finance without thinking about education policy. I'm not competent to do an analysis of education policy *per se*, but I think we should always ask the basic question, "Why do we have the public sector involved in education anyway?" We have to clarify our goals if we're going to clarify our making of policy.

Presumably, one main reason for public sector involvement in education is to achieve some sort of equity objective. We wouldn't be happy with a completely private financing of schools because we would be concerned that some people might be left out. In this regard I think a fundamental issue—I'm not going to address the issue other than to mention it briefly here today—is "Do we address the equity issue by trying to fund school districts, or do we address the equity issue by trying to fund students?" There are many different fundamental educational policy reforms that people are discussing these days, and, if we undertook fundamental educational reform, that would really reshuffle the deck with regard to education finance. I would emphasize that private education does exist, and the number of people that use private education partly depends on how well public schools deliver services to the people of the state. How much reliance we have on private education depends partly on how well the public school system functions.

The issue of SEEK funding was mentioned in the previous session. I won't try to elaborate much on this. It's an intricate system, but basically there are levels of state government support for local school districts to try to ensure that there's at least some base level of financing for local schools. Beyond that base level, the state provides extra support for localities that try to raise additional revenues. That's the Tier 1 Zone of the SEEK Funding Formula — up to 115 percent of the base level of funding. Beyond that, local governments can try to raise additional revenues for local schools, up to 130 percent of the base level of funding, but they do so essentially from their own sources and without support from the state government. There is, in addition to this, a limit or cap for most school districts as to the total amount of revenues that they can raise, which is 130 percent of the SEEK base. This system, then, is an attempt to try to make sure that the low spending districts get up to a certain base level, and there's also some support to raise spending above that.

In practice, virtually all school districts are in the range where they're on their own at the margin. They've taken advantage of the resources that the state government provides, and they're funding most of the last units of education spending from their own resources. How do they do this? They do it through a mix of different kinds of taxes: the property tax; and local income taxes and occupational taxes, which only eight districts actually use. Even though only eight local districts use occupational taxes, it accounts for a significant share of total revenue in education financing in Kentucky, especially because Jefferson County and Fayette County do impose these taxes. Then there's the utilities gross receipt tax, which is limited to a tax rate of 3 percent and is used by almost every school district in the state. Virtually all of them impose this tax at the 3 percent rate.

A question that comes to my mind is why we are taxing utilities in order to finance education. I've puzzled over this. Is there some relationship between utilities and education? If you watch a lot of TV, maybe you need better schooling, so that's a possible explanation. Is it related to one of the basic taxation principles we talked about, like ability to pay? Are districts where they have a lot of people that consume a lot of utilities somehow more able to pay taxes? We have income taxes for that purpose, or consumption taxes, or property taxes. Why would we tax people on the basis of how much they use utilities? Furthermore, if you're going to impose a tax essentially at a uniform rate across the entire state, why are we using local governments to collect this tax? If it's essentially a statewide tax at a uniform rate, it seems like the obvious thing to do would be to think about just moving this tax to the state government for enforcement and for administrative purposes, collect the revenue, and then do something with the revenue. You could give it back to the local school districts, if you like. You might even think about giving it back on the basis of how much cable television people watch. If you did, then you'd be back to where we are today. But I doubt that that's how we'd use state utility tax revenue to support education. I really think that this is an issue that's worth giving some thought to.

More generally, we should come back to this question of tax limits. Should we let local districts tax as much as they want? Would this create various kinds of inequalities or not? I don't want to take more time, except to say that there are some localities that are up against these limits, and there are some that have maxed out on their occupational taxes, and maxed out on their utility taxes, and those districts would try to raise additional revenues if they could. Those districts happen not to be ones that are spending particularly high amounts of money on education. It's not the case that these constraints or these regulations are keeping some districts from spending way above what other districts are spending. The ones that seem to be affected by these caps are ones that are trying to climb up into the midrange, and why do we want to impose constraints on the ability of local governments to do that?

To frame the big issue, and this is going to lead me to my concluding slides here very quickly, let's just think about two stark alternatives. Why don't we get rid of local schools altogether and just make education a state government function? The state already pays for a significant amount of it. Let's just abolish local school districts. Or, let's get rid of states' role and turn it all over to local governments, making education a purely local function. Those are the extreme options. What are the advantages and disadvantages of doing so?

Well, we could achieve, at the state level, very uniform spending. We wouldn't have to make it uniform just by school district. We could make it uniform by school. Or, if we wanted to, we could make it uniform by grade level. After all, why use the school district as a unit for judging whether there is equality or inequality? If we did that, if we made education spending uniform throughout the state, what level would it be? Would it be as high as the best schools today, as low as the least-funded schools, or somewhere in between? There's no presumption that it would be one or the other, but I guess it would probably be somewhere in between. If we did that, it's important to note that this would mean that there would be some schools that wouldn't have as much funding as they presently have. There are some school districts where people are presently paying taxes to pay for more spending for education for their kids. Those people might simply accept less funding for their schools than they presently have.

Alternatively, they might say "the public schools just aren't up to snuff any more; I think I'll take my kids out and use private schools." If we try to make spending very uniform across the state, one implication of that might be that we would encourage significant numbers of people, especially high demanders for education, to shift out of the public school system and use private schools more than public schools. That might or might not be something that you'd like to encourage, but the important point is to note that uniform education spending across the state doesn't in itself imply that there's much uniformity in the educational outcomes in children of different backgrounds. If we got rid of state funding altogether, of course, we might also have unacceptable kinds of inequality in school spending among school districts.

So the real issue is how do we strike a balance between state and local finance of education? I would just conclude by saying that we have to really think carefully about what are the essential state interests in local education. I think we should consider at least deregulating local districts, except where local autonomy is somehow expected to do something harmful to the rest of the state. To come back to the points that I raised before: why have a regulation on local governments, unless you think there's some harm to the rest of the state that's being done by local autonomy? This is my one speech today as an interested party: since I've spent my life in education, I find it completely reasonable that rich people would like to spend their wealth on better education for their kids. I don't see any particular problem with that. Maybe that's offensive to people, and we should limit it. Of course, it means that rich people will have better quality education for their kids than poor people. If we don't like that, then we can try to think about ways to support poor people by financing education for their kids. I would say we really have to come back and think about what are the essential state interests, whether it's equity or whether there are some efficiency arguments for state intervention in local school finance. Perhaps we could rethink a combined system of state and local financing for education with an eye to achieving those more essential policy objectives. Well, I've said a lot of things very quickly, but at least this gets a lot of issues on the table. We should take time for questions.

Ms. Boone

If we have time, I'll read you two questions. I don't know if they have already been answered.

QUESTIONS, ANSWERS, AND COMMENTS

Questioner

I'm a little curious. The slide that showed the relative contribution of state and local funding resources showed that, relatively speaking, local governments are funding a higher percent of education than they were in 1990. Of course, one of the reasons that Kentucky has such a high percentage of funding in education is that it's necessary to do that in order to provide the equity that's demanded by the Kentucky Educational Reform Act. That would imply, though, that the Kentucky Educational Reform Act and the funding formulas that are in it are breaking down, that local governments are contributing more of the percentage and more and more money into education.

Dr. Wildasin

Right. Well, there are underlying differences in the demand for education. There are rich and poor; there are different age groups; there are factors that give rise to different demands for education in different school districts, and those are still there. The Kentucky Educational Reform Act didn't make them go away. So they will tend to re-emerge unless somehow action is taken to keep that from happening.

Questioner

Were the percentages prior to 1990 very different from that?

Dr. Wildasin

I must confess I don't have those figures at my fingertips.

Questioner

Just to add a little bit to this discussion, what's happening is that there's a guaranteed base amount of money for people that the state called a Guaranteed SEEK base and really the whole state funding formula is based on property assessments for people. What has happened over the last 10 years since SEEK came into effect is that property assessments have risen much faster than the Guaranteed SEEK base amount of money. And so since property assessments are going up, revenues from local taxes are going up, and that allows the state to back out on its contribution because the Guaranteed SEEK base amount of money is not keeping with the rise in assessments. There was a nice boost in the base level of funding for schools right after the Reform Act was passed, but then, over time, as the economy has grown and as the revenues have grown, the legislature has not kept pace with the growth in revenues going to public schools. If you actually continue this trend, if they don't change this formula, the two lines are going to cross. The state is backing out of supporting public schools.

Dr. Wildasin

Right. I think the fundamental policy question is, is that a good or bad thing? I mean, that really comes back to the balance between the two.

Ms. Boone

One more short question. Yes, sir, right here.

Questioner

I'll just make a point. On your chart you say that Kentucky is well below property taxation compared to the rest of the country, and my homebuilder friend here might disagree with that to a certain degree. We're leading the nation in education reform and have gotten many people to come to our state for UPS and things like that. But they're able to buy a home in Kentucky that is not nearly as expensive as other states, and plus we tax them lower. It seems to me we're going to get further behind.

Dr. Wildasin

Because we're undertaxing property? I think it's inseparable from the question of what the role of the state is going to be. In effect, what we've done is we've used state revenue sources—the state income tax, the state sales tax—to some degree to displace the local property tax.

Questioner

I know people in Owen County who get a \$250,000 house and in every other state that house would have cost them \$600,000.

Ms. Boone

We're running behind. I suggest you find someone during the lunch hour and sit down and discuss this, but we can take questions for about another minute.

Questioner

I have a brief comment. The comment concerns the charts you have up front. You mention the increase in local revenue and decrease in state revenue, but the other issue, I think, is the fact that the percentage of state revenue going to education has declined in the last 10 years. If you put that same percentage of revenue in education before the Kentucky Reform Rule, the chart completely changes.

Dr. Wildasin

In terms of the state budget, you're saying that the state budget share devoted to education has been shrinking over time? That may well be the case. I know that Kentucky stands out among the states as having high state reliance on state funding for primary and secondary education, which is true as recently as 1997. This does not contradict what you're saying because it might have been even higher in the past. So we are a state that has a heavy state involvement in the funding of primary and secondary education. Perhaps the trend, for the reason you described and what was mentioned before, is shifting a bit away from that. To the extent that that's true, we're probably getting a

little bit closer to national averages, which may be a bad thing if we're trying to achieve very uniform levels of funding for schools across the state, but that seems to be the direction that we're heading.

Questioner

We are having a study done in northern Kentucky of all the cities and counties, looking at revenue and expenditures. Somewhere in the report, that is still in preliminary stages, it identifies the fact that, at the local level, the percentage of taxes paid for state taxes is extremely high in Kentucky versus many other states. I think it was as high as 40 percent of the amount of local money paid to state property tax.

Dr. Wildasin

Oh. You're speaking of the property tax that goes to the state government. Kentucky does, at the state level, collect more in property taxes than is true of most states.

Questioner

Yes. Very high. And that's somewhat regressive as opposed to aggressive.

Dr. Wildasin

Right. Just a quick response. There is a term called cohabitation of tax bases—whether different units of government should or should not tax the same revenue source. You could make the argument that the state government should get out of the property tax business altogether and leave it to the local governments, and I think your question touches on that. We're a low property tax state, relatively speaking, overall, and it is true that the state is involved in the comparatively little revenue we do get from the property tax. One possible argument would be that we want to really liberalize the ability of localities to rely on local property taxes and that gets back to the business of restrictions as in HB 44. That's why I think a fundamental question is, "Why are we regulating the ability of localities to collect taxes from local sources?"

Questioner

By the way, in terms of who's being protected by the limits imposed by HB 44, the ones that are being affected are those districts where property is rising faster than the 4 percent that's allowed, and they leave a very clear trail. The impact is that the district has to lower its tax rate in order to prevent itself from exceeding the revenue limit, so in those districts, you see the tax rate being lowered from year to year in order to comply with the Revenue Cabinet. Usually that means that there is an increase, or influx of population, where the demand for additional public services and infrastructure is greatest and those are the people that are being prevented from raising the rate, in many cases, by those limits.

Dr. Wildasin

You know, I think it's very feasible that somebody could gather this data about exactly which local governments are up against these limits. I think the data exists. It's a big task to accomplish because there are many, many local governments. I think it would be extremely interesting to do that. I suspect that you could be correct in what you're saying. And it comes back to this question of local autonomy. If the local demand for services is there, then shouldn't we let local decisionmakers have the flexibility, basically, to respond to public service demands?

Questioner

So you're saying your chart on the ranges of increase in revenue aren't reflecting which local governments have, in fact, foreseen this limit and maybe done a self-imposed decline of their taxes.

Dr. Wildasin

That's this chart and it only refers to county governments. It doesn't refer to school districts, municipalities, or special districts; any or all of those could be subject to these constraints. It only refers to the past three years, so it's very possible that there are some county governments that have been up against these limits. Whether we're interested in the total amount of property taxes that's being collected in the state or not, there is a real question as to why we want to put limits on the ability of particular localities to raise taxes if local imperatives seem to demand that.

Questioner

One of the underlying goals of KERA, one of the promises even made to the teachers, was that we were going to try to reduce the student-to-teacher ratio. We all recognize that in the long term, the student ratio of over 20 to 1 was not

really the best education possible. I think if you go into higher education, you find that the universities that have smaller classes produce graduates that seem to have a better education.

Dr. Wildasin

Martin School students would be a good example of this.

Questioner

There you go, and I think you prefer that. It seemed to me that that was the underlying promise to the teachers, that we were going to get another body in the classroom so that the reform would allow more individual teaching for more students. Therefore, our goal of having everybody achieve at a high level would have some support.

Ms. Boone

We just need to conclude this session.

Questioner

We talked about changing the local funding percentages, whether it would be local sources or state source. One thing you have to look at is the adequacy. If, as a result of all of this stuff, the state is not raising that base guaranteed amount for school districts per pupil, an adequate amount each year, then you're really losing out when it comes to purchasing power for your students and you're worse off now than you were right after the Reform Act was passed because the increases have been so minimal in those years. In fact, it's gone up about 2 percent a year, something like that, and the cost of living has gone up much more than that.

Dr. Wildasin

I think what you're saying is that you'd like to see more money spent on education. For me, that is an easy sell, but I have to say that there are other competing uses for public resources and other private uses of resources. There is a real question as to how much it is proper for the state to try to raise the level of education spending throughout the state. I will just mention parenthetically here, to reiterate what I said before, that most of the school districts are in the Tier 2 Range, which means that they've already outgrown the state support that is provided. So it's probably not the case that the state is providing a big impetus to local increases in school expenditures at the margin. If you think it should be, then that's a reason to revisit the SEEK formula. It's an open question as to whether you want the state to try to promote ever higher levels of education, and how much. As I say, for me it's an easy sell, but I think that is a real issue here. And we don't want to assume that just because the state's involved in school finance, it's going to be higher, at least for some districts, because I think the more the state's involved, probably the more it tends to move to an average or in-between level.

Ms. Boone

We thank you all for coming. We thank you for your attention, and we hope it's been worth your while.

THE HELLARD AWARD

Representative Stephen Nunn

Board of Directors, Chair
Kentucky Long-Term Policy Research Center

Thank you very much. I know you enjoyed your lunch and now we would like to start the afternoon proceedings. I would like to welcome some folks who have come today for the afternoon session. Before we continue our discussion of tax policy, we would like to take this opportunity to do one of the most important activities of the Center, and that is to present the 5th Vic Hellard Award. I don't know how many of you have visited the state Capitol, but if you take the elevator on the east side of the Capitol to the third floor and look to your right, there in front of you will be a bronze likeness of the late Vic Hellard, Director of LRC, and the inspiration behind our Center. On the plaque we have Vic's likeness and an inscription as to why we present this award. On a wall close to the plaque are the names of the previous winners of the Hellard Award. So if you are on the third floor of the Capitol, please take time to visit that area. Today we present the 5th Vic Hellard Award, but before we do that, I would like to introduce the four previous award winners.

In 1997, the winner of the Vic Hellard, Jr. Award was the distinguished jurist, Judge Anthony Wilhoit. Judge Wilhoit is with us. Please stand, Tony. (*applause*) Judge Wilhoit served for 21 years on the Court of Appeals and as its Chief Judge, Judge Wilhoit's impeccable reputation for integrity and fairness serves him well in his current post as Executive Director of the Kentucky Legislative Ethics Commission, the chief office of decisions about legislative conduct. I bow to you today, sir. (*laughter*)

Our 1998 winner was Mr. Joe Kelley. Joe is here with us today. Please stand, Joe, and welcome. (*applause*). Joe, during his tenure as Chairman of the Kentucky Board of Education, from 1991 until 1998, became synonymous with education reform and the pursuit of educational excellence in Kentucky. Joe Kelley played a key role in one of the greatest and most notable challenges we have ever undertaken in this state. He now serves as the President and CEO for Columbia Gas of Kentucky.

In 1999, we recognized Mary Helen Miller. Please stand, Mary Helen. (*applause*) During Mary Helen's lengthy tenure in state government, she became a symbol of what women could achieve in the Commonwealth. Rising from the classroom, where she began her long career of giving back to her beloved state as an elementary school teacher, to high-level posts, including that of Cabinet Secretary, in both the legislative and executive branches and under two Governors.

In the year 2000, we honored Al Smith. I don't believe that Al has made it today, and we miss him. Al is perhaps the state's most distinguished journalist, whose rich sense of history dazzles his friends and colleagues, and whose generosity to his adopted state has made him a beloved personality. Al is a former newspaper publisher, editor, and reporter, and currently hosts Kentucky Education Television's longest-running program, "Comment on Kentucky," now in its 27th year on the air.

But today it is with a great sense of pride, on behalf of the Kentucky Long-Term Policy Research Center Board and staff, that I am pleased to announce the recipient of the 2001 Vic Hellard, Jr. Award. This year's recipient is Dr. Thomas D. Clark. As biographer Bill Cunningham noted, Dr. Thomas Clark is not only a highly learned and distinguished individual, he represents a uniquely resilient and historic American generation. Born on the tails of Reconstruction, he has witnessed two world wars and the emergence of this country as the strongest nation on earth. The experiences of this age group have included the revolutionizing trauma of the Great Depression, racial upheaval, divisive wars, and monumental political scandals. While many only survived and some became embittered, Dr. Clark continues to demonstrate vision, taking into consideration the long-term implications of activities and policies in order to promote the common good and the public welfare. He demonstrates innovation, finding new ways to approach challenges that face government, while at the same time fosters a reverence and appreciation for history. Dr. Clark certainly promotes public dialogue on issues, fosters greater public involvement in civic activities, and approaches his work with caring, generosity, and humor. With Dr. Clark today is his wife, Loretta, son Bennett, and daughter Elizabeth Stone. It is with reverent appreciation that we present the 2001 Vic Hellard, Jr. Award to Dr. Thomas Clark. (*thunderous applause*).



Dr. Thomas D. Clark
2001 Hellard Award Recipient

DR. THOMAS D. CLARK

2001 Hellard Award Recipient

Ladies and Gentlemen, first of all, I will say I feel humble indeed, not only in receiving this award, but also as a token of a warm friendship that I had with Vic Hellard. I thoroughly enjoyed Vic in many ways as a public official of high integrity, a good sense of humor, and a sense of how things should be done. I had lunch with him just before he died, one of the great sorrows in my life. But I'm also happy to be here today with Ellen. I've known Ellen, for a few years back, and I held this sweet little bright-eyed girl on my knee. Today, I offered her to sit on my knee, and she won't do it. (*laughter*)

It would be preposterous for me to talk about taxation. All I know about taxation is every November I get a lot of envelopes that I wish that the mail had lost. (*laughter*) Nevertheless, I spent very many years trying to understand Kentucky, trying to acquaint myself with the forces of the changes, with even the magic of the history of this Commonwealth. I cannot tell you the times I think in the last five years I heard every Governor's message, and I've spent a tremendous amount of time reading the acts of the General Assembly, the journals, and other public documents. If I could write the history of Kentucky in two words, I think of only two words that fit very well, and those would be "short fall." Over and over and over, I've come on to that treacherous situation in the history of this Commonwealth. Over and over, I've read the Governors' message/pleas for some kind of orderly arrangement of Kentucky's fiscal affairs. I think I can almost say that that was a unanimous call. Every two years, the Governor has made that plea, and the General Assembly responded in various ways. I heard just a part of the discussion, before lunch, in which House Bill 44 was mentioned. I have no idea of what impact HB 44 may have had in a positive way, or in any other way, so far as the fiscal changes are concerned, but I am strongly of the opinion that the time has arrived in this Commonwealth when these negative barriers should be removed. I thank our state for every Governor, and many, many of the legislators in the past, when I say it is heartening indeed, in this day of transition, in this day when Kentucky is faced with so many fundamental changes, the changes that have taken place, and the changes that will take place in the structure of its economy, the structure of its society, the structure of this country, every political image you might mention. We do not need to go into the future with any more negative barriers or cycles than we already have. I think this time is one of the most interesting periods in the Commonwealth's history. If you go back to all the various chapters, various periods of development, none of them have been more challenging than I think this age has already been, and certainly will be in the future.

There are negative things that can be erased. It is so important that this tax policy is concerned with this matter, that you can make orderly procedures—orderly approaches to the future. We need to erase some of the old political glories, some of the old customs that were fitted to a very rural society. Kentucky no longer is living in that age. It no longer is meeting challenges of that nature, despite the fact that you drive across the bosom of this Commonwealth and see what phenomenal changes have taken place in the past. It is at an age in which Kentucky will grow with a new, fresh, and forceful direction. We have made phenomenal progress. I've known this Commonwealth, and I think I can say almost intimately, for the past 75 years, and I can hardly believe that we have made much progress in so many areas. My concern is with the past and with the functional present; we have come a long way in the manner of recordkeeping, so that we do have some guidelines into the past. We have accomplished wonders in the 120 counties of this Commonwealth, in the preservation, the restoration, and the redesigning of the public records that mean so much in the function of government.

I sometimes walk across the campus of the University of Kentucky and remember what it was like when I entered that institution in 1928, and what it is like today. You can hardly reconcile the differences between those two dates. In the field of education we have a golden opportunity, to redirect the course of our social, our cultural, and certainly our economic future. I think we can take deep satisfaction from the difference between small committees being concerned with some of the fundamental issues of the Commonwealth, and the drawing together of a group of people who are much better trained, have a much broader perspective, a much more able understanding of the forces of change. Historians should never make a prophecy, and I think the shape of the handwriting is legible. Change is going to come fast. It has come fast and historically is a dominant factor in the future of this nation and of the world itself, and certainly, that is going to be the fate of the local community. It has been a privilege to have had the experience of living in this state and seeing the changes that have come, seeing the efforts that have been made over and over. Early this morning, I had occasion to do a little checking on a book that I have published on the Reform Act of 1936, a rather simple statement with some complex parts, in the acts of the General Assembly. But,

nevertheless, it was one of those transforming moments in which Kentucky was bolted out of the 19th century and entered into the 20th timidly, they said, but nevertheless I see in this time, where there are so many challenges, that we are so much better equipped to meet those challenges. But they must be met if the future is to have a brighter history than the past has. Thank you very much. (*standing ovation*)



Representative Nunn

Thank you for everything you mean to the Commonwealth of Kentucky. Certainly it takes a great man to put into two words why we have all gathered here today. (*laughter*)

Your agenda should show that Dr. Bill Fox was to be our afternoon speaker. Unfortunately, Dr. Fox is having open-heart surgery today in Tennessee. I don't know if that is a reflection on what he has found the condition of Kentucky to be, but we certainly wish him all the best, and we appreciate his work on behalf of the tax policy subcommittee. We have a noble replacement today, someone we are very proud to call a Kentuckian, Dr. Gordon Davies, President of the Council on Postsecondary Education. Dr. Davies has agreed to speak to us today on this critical issue, which we continue to prioritize for the future of Kentucky. Dr. Davies' biography is not in your book, and if there is anyone in here who does not know who Dr. Davies is, I would suggest that, after he speaks, you excuse yourself, go across the singing bridge, turn right to the Second Street School there, and they would be able to help inform you. With that I am going to introduce Dr. Gordon Davies. (*applause*)

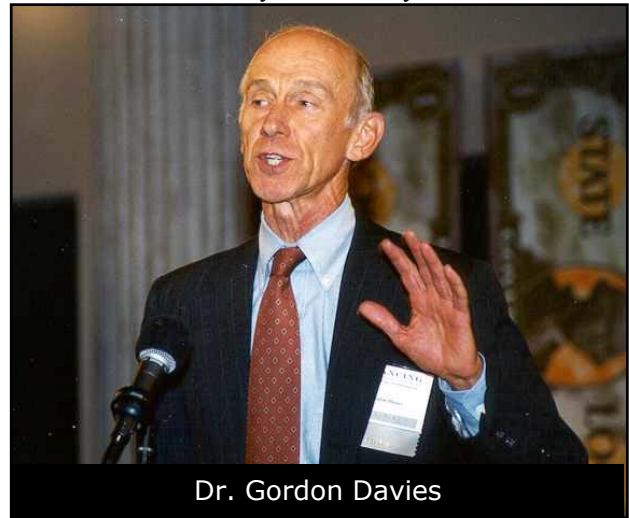
KEYNOTE ADDRESS

Dr. Gordon Davies

President, Council on Postsecondary Education

Well, thank you very much, ladies and gentlemen, and, Mike, thanks for inviting me. After hearing Dr. Clark speak extemporaneously as a recipient of the Hellard Award, I don't blame Bill Cox for having open-heart surgery. You've got to really not want to come to have open-heart surgery. Senator Sanders must have scared him away; I don't know, maybe Representative Moberly did, I don't know. Well, another wise thing that Dr. Clark said, that I echo, "it would be preposterous for me to talk about taxation, so I won't." But I will tell you the absolute truth about how Mike called me yesterday. He called and said, "Bill Fox is having open-heart surgery, and would you fill in for him? And it caught me a little by surprise (*laughter*) and I stalled for time and I said, "Gee, Mike, there must be a dozen people in Frankfort who are better qualified to do this than I am." And Mike said, "I know that, Gordon, and I've asked every damn one of them." (*laughter*) It is really kind of embarrassing. I'm the only person in Frankfort who didn't have a full calendar today. I've got to work on that. Not only that, I got the rest of it figured out—I'm cheap, because I had already paid for my lunch. (*laughter*) So that's what you get. What you get is also a kind of comic relief. Here is a guy representing a major segment of the state budget that has been exempted from cuts and I'm here to tell you how important postsecondary education is and why it's a good decision to exempt colleges and universities, as well as public schools, from reductions. So if you believe that, I also have a bridge that I want to sell you—(*laughter*)—connecting Brooklyn to Manhattan. One good piece of news is that I am not going to talk about tax structure or about revenue modernization, which I think is probably the latest euphemism for tax reform. I'm not even going to talk about economics. The only conversation I have had about economics, since coming to Kentucky more than three years ago, was in the Senate A & R Committee when a senior Senator said to me, "I'm all for supply-side economics, Doctor, as long as my side is getting supplied." Well, I think they gave a Nobel Prize for the theory underlying that pearl of political pragmatism. I am going to talk, instead, about education, for the simple reason that it is what I know and what I do. A woman once asked Mark Twain how much he charged to give a speech. "Well, it depends. If it's my topic, it's \$10. If it's your topic, it's \$20, but either way you get the same speech." (*laughter*) Well, you get mine.

I am, however, deeply uncomfortable about the budget cuts and deeply uncomfortable about postsecondary education's exemption from them. We have taken these cuts at the Council, just like everyone else. I know that they hurt. I know that there are things that we don't do now that we had done. Everyone except the schools, the colleges, the universities, have taken the cut, and yet the colleges and universities not only of Kentucky but of America are among the most privileged of social institutions. They probably can take cuts more readily than other parts of government that provide direct services to children, women, and men, in our state, and indeed, in every state. Not only that, but colleges and universities have the ability to generate revenue from tuition, tuition being a kind of "special use" tax imposed on those who enroll as students, so they can generate some of their own revenue. Why then exempt educational institutions? The answer is simple, it is almost embarrassing simple: because it is the only way out, because it is the next stage of the progress that Dr. Clark spoke so eloquently about just a few minutes ago, because it's the ramp into the 21st century. We have to create intellectual capital, so it can in turn create the new companies that offer careers to Kentuckians. We have to create an educational culture that complements



Dr. Gordon Davies

the incredible beauty of this state, that makes it a place to which people want to move. We have to create a workforce that is skilled and knowledgeable, a workforce that is able to fill the new jobs that are going to draw the American economy, and indeed, the world's economy. This is not a matter of a new economy versus an old one. There is enough high technology in the Georgetown Toyota plant to satisfy any techno-geek. It is a matter of changing our state's behavior toward higher education, convincing every man, woman, and child that the way to a decent life, and I mean decent to include more than earnings, is through study beyond high school. It is a matter of convincing voters and communities and business leaders that research isn't just something done by pointed-headed lab rats in Massachusetts, or on the west coast, it is the difference between operating in the black and filing for Chapter 11 bankruptcy. Here is what the *New York Times* had to say about the interior south yesterday, the interior south being Alabama, Arkansas, Louisiana, Mississippi, Tennessee, and Kentucky. "With great fanfare, much of the eastern United States diversified its economic base over the last two decades, luring giant auto companies, sprouting new technology centers, and raising new hopes that the region would not only enjoy greater prosperity, but weather hard time better in the future than it had in the past." Instead, the article goes on, the opposite has happened. Even before September 11, the south was mired in its worst downturn in almost two decades. The old "Bible Belt" has become the nation's new "Rust Belt." It is not that there is no need for mental health or children's services, it is not that there is no need for better roads. My goodness, drive around with Representative Barbara Colter some day and visit the people in Owsley County. One of them will tell you that it is the only county in Kentucky where you've got to pay a toll to get in and you've got to pay a toll to get out. It is not that there aren't needs everywhere, but it seems to me that we have to invest long-term in education if we ever are going to improve the quality of living here in Kentucky. We have to break the cycles, cycles that we have made such progress dealing with in the 20th century. We have to break these cycles of poverty, illness, illiteracy, and ignorance. For the past several years, there has been enough money to invest both long term in education and meet immediate needs. Now there isn't.

When I was a computer salesman, at another stage of my checkered career, when I came across firms, this was way back, that faced an economic downturn, you could poll the ones that were going to have trouble. They were the ones that closed down their information systems and their product development. The ones that were going to succeed didn't do that, and I don't think we can do that either, as a state. We have to invest in the long run. If immediate needs have to be met, then our political leaders should create more revenue to meet them. But we have to invest long term. Now, it is easy for me to say that and not talk about tax policy because I don't know anything about tax policy. I remember that during World War I, German submarines were menacing shipping in the Atlantic, and they didn't know what to do about it. Will Rogers, great folk entertainer of the time, went to Washington, D.C., and he said to the admirals, "I know what to do about this submarine problem. You just pop the heat in the Atlantic Ocean up and get it hot enough, and you will cook the submarines like lobsters, and they will pop to the surface, and then you just scoop them up." And the admirals said, "Well, that is fascinating, Mr. Rogers, but how do you propose we heat the Atlantic Ocean?" Mr. Rogers replied, "That's a technical problem. (*laughter*) You asked for a solution, and here it is."

Well, how you raise the revenue is a technical problem. Senator Sanders and Representative Moberly spoke today to that, and I am sure others have, and will. But after I decide what I want to say to the local Rotary, or the university faculty, or even as a pitch hitter on an occasion like this, I subject my thoughts to the "old man" test. Would my father have believed it? And I think the answer is no, he would not have believed it. I think that is because he is the product of the Depression, barely a high school graduate, who barely knew how to make much money and never did. He didn't expect much change in his life, and he got just about as much as he expected. Yet I was privileged. I was lucky to go to college and gain a sense for the unlimited potential of human aspiration and human creativity. We can make a difference from generation to generation. Dr. Clark has testified again most eloquently to the differences that have been made from 1928 until today. We are already making a difference with this postsecondary education reform, proposed by Governor Patton in 1997. Since 1998, enrollment in our state's colleges and universities has increased by 19,000 students, and for the first time ever, Kentucky has over 200,000 students enrolled in public and private colleges and universities. We expect another 6,600 to enroll next year. We now have a dynamic community and technical college system that blankets every Kentucky community. Every Kentuckian is within 30 miles of a community college, a technical college, or a regional center. We have increased our university research over 40 percent at UK and U of L since 1998, from \$121 million of externally funded research to \$173 million, an increase of over \$50 million. Our goal is \$500 by 2010 and \$1 billion by 2020—we can make it. For the first time, our research universities are working on a single agenda, and this is all good. Its real effects are long term. Speaking to the University of Kentucky's trustees, oh, two years ago, Governor Patton said that if we achieve the objectives of postsecondary education reform by 2020, we will reap the results by 2040. We are in this for the long haul, or we might as well not be in it at all. I think, then, that I speak not only for myself, but for my colleagues, the presidents of our universities and the president of our community technical college system, when I say that we do not regard exemption from budget as a privilege and that we certainly don't regard it as something we deserve. We regard it, rather, as a responsibility that has been assigned to us. We accept that responsibility and we don't intend to fail. We also accept the possibility, indeed the likelihood, that budget

reductions will be required of us, either in this fiscal year or in the next, but reform will go on. Reform will go on as long as the General Assembly and the Governor of Kentucky believe that it is not only a way, but the only way to help Kentucky and Kentuckians everywhere throughout the state achieve better lives, healthy lives for themselves and the children. This is good work, and I am glad we are doing it together, and I thank the Long-Term Policy Research Center for the very valuable, dispassionate look it takes at various topics, including education, as we move to accomplish what is a common goal. Mike, I thank you for inviting me to fill in for Bill Fox, for whom I very much wish a speedy recovery. Thank you, ladies and gentleman.

(applause)



Representative "Gippy" Graham talks with Ron Crouch and daughter Alicia.



Panelists for the KET-Kentucky Long-Term Policy Research
Center Presentation of
"Financing State and Local Government: Is Kentucky Making
Progress?"

Front Row

Walter Baker, Anne Joseph, Steven Reed

Back Row

Larry Whitaker, Karen Cunningham,
Bill Lear, Mike Duncan

THE KET-KENTUCKY LONG-TERM POLICY RESEARCH CENTER PANEL DISCUSSION, "FINANCING STATE AND LOCAL GOVERNMENT: IS KENTUCKY MAKING PROGRESS?"

Moderator

Bill Goodman, host of Kentucky Tonight

Panelists

*Walter Baker, attorney, former Kentucky Supreme Court Justice
and member of the Kentucky General Assembly*

Karen Cunningham, Mayor, City of Madisonville

Robert Michael Duncan, Chairman and CEO of Inez Deposit Bank

Anne Joseph, Director of the Kentucky Task Force on Hunger

Bill Lear, attorney and former member of the Kentucky General Assembly

Steve Reed, attorney and former Kentucky Deputy General Counsel and U.S. Attorney

Larry Whitaker, McLean County Judge-Executive

Mr. Goodman

Let's just say, for all practical purposes, for the time that we have today and for the purpose you serve here today, that all bets are off. The slate is clean. As I heard Centre College President John Roush say just the other day in an address, "Burn all the cue cards, throw out all the recipes, toss out all conventional wisdom, start anew." I want you to start anew today. Walter Baker, when you look at tax policy in the state of Kentucky, do you consider all possibilities are on the table, or have we been there and done that, and we need to move on?

Mr. Baker

We've been there, we've done that, and we need to sit down and do something to expand our revenue base here in Kentucky. I think it's going to be an incremental type of approach rather than what we did in the General Assembly in 1990 in education reform, where we started from zero, and had to put everything back together.

Mr. Goodman

Bill Lear, you bring a certain amount of history to this discussion today. Tell us a little bit about what we have done before and how we got to where we are today.

Mr. Lear

I started to say, when you asked the question to Walter, that we've been there and we've talked about it, but we haven't done a heck of a lot. In 1994 and 1995, Pat Malloy and I cochaired the Kentucky Commission on Tax Policy, and we dissected the tax code from top to bottom. We came up with a wide-ranging set of recommendations to try to modernize the tax code and to hit issues of adequacy, competitiveness, simplicity, and fairness. We came up with a series of recommendations, and by happenstance one or two of them have been implemented, but basically, it was put on the shelf, and nothing was done with it. The legislature is back in another tax code review, as we sit here.

Mr. Goodman

You have expressed yourself before, in that you found yourself five or six years ago in sort of the same state that we find ourselves in today.

Mr. Lear

The similarities are eerie. We had passed the largest tax increase in Kentucky's history in conjunction with KERA in 1990. It was just coming into effect in 1991 and 1992, and by 1994, we were already to the point of the state government holding tax refunds back—you may remember that, holding them back and not sending them out timely—so we could balance the budget. And then there were salary freezes, there were cuts, just like what's happening now. In the interim, we've been through the biggest economic expansion in American history, and now we're right back to where we were in the early '90s.

Mr. Goodman

Mike Duncan, we're going to see some facts and figures in just a few minutes that will bring us up to date and give us a road map on where we are and some suggestions on where we need to go. But, first of all, let me ask you your thoughts about revenue, about the shortfall, and about tax policy in Kentucky.

Mr. Duncan

Well, I think it is a two-step process to continue the dialogue. The first step is that we have to do something about the next budget, and I see this as a continuation budget. We're in the throws of a recession. We did have a long economic run, but this recession started last November and then we had the effects of war. There aren't many people in this room who have lived through a Kentucky General Assembly when there was a war. So I think a continuation budget is one of the things we're going to be looking at and that's step one. I think step two is fundamental tax reform for Kentucky; it's called modernization today. But I think it takes leadership by the Governor and by the General Assembly, and I think it will take a special session, and a recognition that all the players have to be at the table. We have had a lot of divisiveness in the last couple of sessions and part of that is growing pains. We're not used to having a two-party state in Kentucky. We have that, we have to recognize that, and we have to bring people together.

Mr. Goodman

A lot of people have concerns and opinions about what's going on in the state. We talked to a couple of those people, and I want to show you their profiles right now. We will hear from KET's Renee Shaw.

The following is a transcript of a video shown to the conference audience and narrated by Renee Shaw.

Ms. Shaw

Winford Holt is a retired toolmaker and inspector from Ford Motor Company. He now spends his days farming and doing community work in the town of Smithfield, actively working on behalf of senior citizens.

Mr. Holt

The concern, for a lot of people, is that they have to leave their medicine off to buy food. They have to make a choice between buying medicine and buying food. And I don't think that's right.

Ms. Shaw

So it's not surprising that health care and social services, particularly for the elderly, are top-ranking concerns for him. He's even working on legislation that would give a tax break to families who keep their ailing senior parents or loved ones at home, rather than seeking nursing home care. We asked him to take a dollar's worth of change and allocate how much he thinks state and local government actually spend on services. He said, "50 cents for infrastructure, 30 cents for health care, and 20 cents for education."



Winford Holt



Lori Davis, attorney

Ms. Davis

If I were the person in charge of such matters in Kentucky, I think I would place most of the money that we have in education.

Ms. Shaw

Lori Davis is an attorney and Hearing Officer with the Cabinet for Health Services in Frankfort. We posed the same question to her.

Ms. Davis

"I would have 35 cents for education, 25 cents for public safety, 35 cents for health care, and 5 cents for infrastructure."

Ms. Shaw

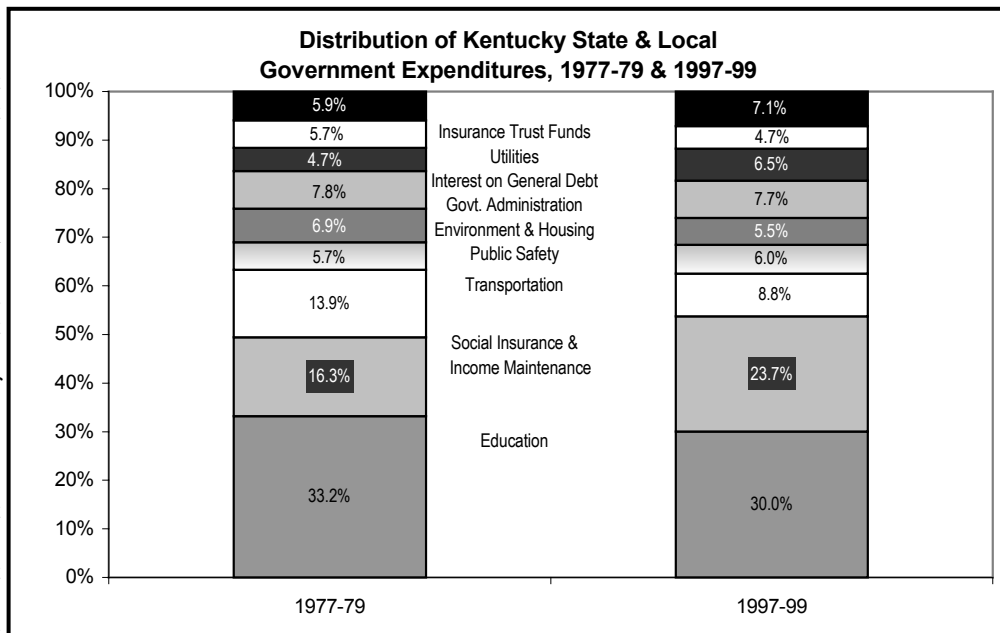
But Davis stated that she would actually like to see 60 cents of each state and local government dollar go towards education.

Ms. Davis

I believe that education is the most important aspect where the government can spend the money that we as taxpayers provide. I think that education will enable all of us to move forward in the future, and make Kentucky a greater state than it is already.

Ms. Shaw

And policymakers have recognized that sentiment over the last decade. Education spending, according to a report by the Kentucky Long-Term Policy Research Center, has increased significantly in recent years, and consumes the largest portion of the state budget. But, the report points out, the portion of state and local government spending on education is less today than it was 20 years ago. This chart shows that



from 1977 to 1979, almost 33 cents of every dollar spent by state and local government went to education. That number, from 1997 to 1999, dipped to 30 cents of every dollar. Social services, on the other hand, have enjoyed an increase in state and local government dollars in the last 20 years. Almost 24 cents of every dollar is dedicated to social services, which includes health care and hospitals, as compared to 16 percent from 1977 to 1979. Transportation spending has decreased in the last two decades, while state and local government dollars increased minimally on public safety. Both Winford Holt and Lori Davis hope that policymakers will manage state and local government dollars in a way that strengthens the state and meets the needs of all of its citizens, which are often two competing interests and a tough balancing act for lawmakers in tight economic times.

End of video

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Mr. Goodman

I would think you would probably agree that education and the thrust that we are taking in the Commonwealth now is important.

Mr. Reed

I think it's more than important. I think it's critical. I think it's vital. If you look at today's importance of education, I think one has to look around the world, and you have to look at history. In doing that, if you look at the role of government, the government should do two things: provide its people freedom and provide its people education. If it can do that, then the people can make the most of the education, and thus make the most of the world. If you look at America, in its relative youth, it's mind boggling to consider the mark on history that young America has made. And in fact, if it weren't for the recordings of America's contributions to the world, recorded in history, I think it would defy the imagination to believe it. But at the same time, if you look at America and contrast it with another country, Russia, the former Soviet Union, you can see that there's a distinct difference. And that difference comes down to, again, the philosophies of the two governments on freedom and education. It's almost as simple as the old saying, "give me a fish to feed me for a day, teach me to fish and feed me for a lifetime." In many ways, the Russian government is still giving its people fish. And in many ways, the Russian people are still asking its government for more fish every year.

Mr. Goodman

Does it surprise you, at all, that the increase has been somewhere in the neighborhood of 45 percent over the last four or five years?

Mr. Reed

Well, it does surprise me, but you have to look at it in a historical context as to what it was before that. If we were at the top, in terms of educational spending, then that additional increase could be a little more startling or cause me to wonder whether we're being more effective with it. But I think one has to look at where we were years ago, for instance, where we were in 1960 when Terry Stanford became Governor of North Carolina and ran on the platform of education. I think we have to, as Kentuckians, look to what has happened in the state of North Carolina, and we have to understand that the increase that we've had is relatively recent, and therefore, it's going to take a little longer to pay those dividends that we deserve.

Mr. Goodman

We talked about the 45 percent, according to figures we just saw in that report, in the past 20 years, and even with that increase, we're still spending less today than we were 20 years ago. So what will more money mean to education in the state of Kentucky, and what are we going to get for our dollar?

Mr. Reed

That is an excellent question, and I think every Kentuckian has to ask himself and verify that our leaders, our government, know the important distinction between spending and investing. When we spend money, we look at it differently than when we invest money. When we invest money, we want to know the return. We watch it; we want to see what it produces for us down the road. We have to make sure that we don't just spend money on education, or that we even spend money on government services, but, when it comes to education, we have to invest money. Therefore, we have to keep a keen eye on what it's going to produce for us and what it's going to yield. If we do that, you have more accountability, you have more results to show for it.

Mr. Goodman

Anne Joseph, until recently, a year ago as we've heard, the economy was just humming right along. Yet, I think, statistics will show us that one in four children in Kentucky live in poverty. Talk to us for just a few minutes about the state budget, tax policy, and what it means to families and children that you deal with.

Ms. Joseph

Well, we know even during the time of prosperity, there has been a growing income gap between the poor and the wealthy, and in Kentucky that has been true as it has been around the nation, but even more so in Kentucky. So even in good times, the poor are not doing much better than they have done in the past. We also know that state tax burdens are the highest in Kentucky as compared to other states. And we start to tax our low-income families and low-wage earners at \$5,400 for a family of three. I mean, that has to be questioned. If we're wanting to help people and families move out of poverty, we certainly need to have tax policies that recognize that perspective and that, in fact, do not push more families into poverty. We've had an emphasis on moving families from welfare to work, but also we have a long history of low-wage earners in this state, and families really need to be supported by changes in our tax policy, as well as looking at a state refundable, earned-income tax credit, which can assist those families.

Mr. Goodman

There's no question in your mind that we tax the low-income unfairly? Mike Duncan.

Mr. Duncan

But this morning we saw the results of that. Who we're taxing unfairly are the working poor in Kentucky.

Ms. Joseph

That's what I'm talking about, that it's not the very lowest of income but those trying to rise above that, who we're taxing unfairly. Well, there seem to be some dueling studies at this moment, and we're just going to have to sort out the information. I know we have worked and presented studies which do show tax burdens on low-wage earners, and that's what we are talking about. The low-wage earners are either the highest in Kentucky, or the second highest, and then we're grateful for Alabama, because that moves us to number two. I know, I heard the discussion this morning, and I will have to put those studies side by side and see how they hold up. At this point in time, the work that's being done on the reports that I've been working with show that there is an unfair tax burden on low-wage earners in Kentucky and that some families, in fact, move more deeply into poverty when they do, in fact, have wage earners in the home.

Mr. Goodman

Mayor Cunningham and Judge Whitaker, it has been said many times that this is really not that complicated a process, that it's pretty simple. When people spend less, the economy goes down. When people spend less, we don't take in as much sales tax as we need to bolster the state's economy. What does this say to what cities and counties do? How do they react to this?

Mayor Cunningham

Well, it's always a very difficult situation to consider for local government because we are limited as to the income, the revenue sources that we typically have, and so we often look to the state to provide us with some resources or to provide us with some of that money that our citizens have paid to the state. We feel that impact because there perhaps are not as many grants available to municipalities, or something of that nature. So we feel an impact as well.

Judge Whitaker

I believe that the requirements of local government, to a greater extent, are almost inverted from what the priorities are of state government. In saying that, just for education, and when you look at public safety, 30 to 33 percent of the dollars from state government are going into education. Our need, our responsibility, our charge, as local governments, is maintaining jails, roads, sewers, water plants, and our public protection. Those are the very categories that have typically less spending directed to them from the state level. So one thing that I think that cities and counties are working on, and Karen and I, with Senate Bill 163 and other bills, is that together, as we cities and counties agree as to how best to fund priorities, we present that to the legislature, and other than property taxes and taxes on wages, those are our two revenue streams. There aren't utilities or a coal severance tax, unless you are lucky enough like Hopkins and McLean counties to have coal severance funds. So the dollars that we need to operate county government primarily, I feel, go toward public safety, and to infrastructure, and in creating those dollars, those are very expensive. We have explored other opportunities, deed transfers, sales tax, many things that I think can be framed; however, our charge, I believe, to the General Assembly is to show that we're responsible enough and accountable enough at the local level to invest those dollars wisely and not just spend new taxes.

Mr. Goodman

Mr. Lear, let me ask you to react to a couple of statements here. The first one is that Kentucky's tax system has evolved piecemeal with incremental changes legislated in each General Assembly session.

Mr. Lear

I think that's exactly true. If you look at the principal revenue bases for our tax system, we have a property tax which, as you heard Dr. Clark say, is limited significantly by a change that was made in the late '70s in a special session that is a real page out of history. We've had income tax for some time and we had a sales tax that came in the early '60s and was augmented when Bert Combs introduced the first one and Governor Nunn added to it. We added a penny to it in 1990, and then what you've seen is various exemptions that were politically popular. Food was taken out of the sales tax. It wasn't originally exempted, but it was exempted at that point in time. Other exemptions have crept in and they have been piecemeal. It has never been done with any overall vision and never been done with any real appreciation for the impact over time. And never, in the last 30 years, has anyone asked, "Does our revenue base grow as the economy grows?" We're so out of sync. We have a 1950s or '60s tax code in the 21st century.

Mr. Goodman

Let me ask you react to this one. Kentucky's tax system is often confusing, and at times has invited litigation.

Mr. Lear

And that's a great system for the lawyers. (*laughter*) Those of us that are in that, we ought to thank the Lord every day for our tax system. With all of the loopholes, and all of the confusing parts of it, it does create opportunities for litigation, but they also create slippage, and they make it a lot more difficult to deal with. One of the things we looked at in this review in 1994 and 1995 was the idea of simplicity. We could adopt the federal adjusted gross income and the federal itemized deductions, and we could all file a one-page Kentucky return and just append it to a copy of our federal return. We don't do that, but we could, and we could do it in a way that's revenue neutral, if we chose to do that. And there are dozens of other things that we could do to simplify the code we just haven't done.

Mr. Goodman

Walter Baker, here's one. Kentucky's tax system has not kept up with the changes in the economy and changes in lifestyle.

Mr. Baker

Oh, that's certainly true. Many Kentuckians today do many, many purchases over the Internet. There's no sales tax generated to Kentucky by that unless it happens to be a company that has a presence in Kentucky itself, which most of them don't. I remember back in 1990, I think Wallace Wilkinson proposed that we expand the sales tax to services. I was a legislator at that time and at the time, I wasn't very enthusiastic about it. But, looking back, services is the expanding part of our economy today. If it's not subjected to some fair type of taxation, we're not going to get the benefit that we need to provide the services that Kentuckians demand. Now there is something else that we need to do, that at times we have not demonstrated great progress on. When we do have good times and we have a surplus of revenue, as we did in '98 and 2000, then we spend it like drunken sailors. We don't look ahead to the times that we are now facing today. To Governor Jones' credit, he proposed and the legislature funded a Rainy Day Fund. Governor Patton expanded that and had we not had that today, the hole would be much deeper than it presently is.

Mr. Goodman

Mike Duncan, you wanted to add something?

Mr. Duncan

Well, I'm concerned about compliance. Walter talks about the Internet, but let's talk about catalog sales and the amount of revenue that's lost through catalog sales and the unfairness to the Main Street merchants in Kentucky. So it's more than the Internet. I think we've got to let the Internet develop. It is not that we, as a state, are going to be the mechanism that can tax the Internet if it's ever taxed; I think that's a function the federal government will play a role in. But when people lose confidence in their government, whether it is on the collection side or whether it's on the spending side, when we have fraud in government, when we have bribery for state contracts, people lose confidence, and we start losing revenue with that.

Mr. Goodman

Anne Joseph, you have a comment?

Ms. Joseph

I think post-September 11, we really have a very different feeling about government, and what we think government should be doing for us, and what we think we should be doing together with government. Our expectations are such that we now need to look at how we fund those expectations. We really do expect government to offer services and to protect us and to take care of all our citizens and to be able to wage war at home and abroad, and to offer all kinds of amenities and important services to all our citizens that, I think, just on September 10, we were really not willing to recognize, but we assumed that we just sent everyone a bit of money and they would take care of their own needs. I think now we need to have a whole new way of looking at government, of acknowledging its role and place in society, and how we're going to fund the kinds of services we need. We also need to look at issues of program integrity and how best to offer these services. But we really need to, I think, have a new way of looking at and talking about the role of government and funding government.

Mr. Goodman

So how is the state's revenue shortfall, and any talk of tax modernization that we're having here today, tied together? Well, for a couple of answers, we turn to State Budget Director Jim Ramsey and once again KET's Renee Shaw.

The following is a transcript of a video shown to the conference audience and narrated by Ms. Shaw.

Dr. Ramsey

The Kentucky economy has had a really nice run. We've had 18 years of growth. But it all came to a stop last November and December.

Ms. Shaw

"That's when," said State Budget Director Dr. Jim Ramsey, "the state's economy dipped because of a slowdown in manufacturing jobs."

Dr. Ramsey

I like to say that the light switch was turned off in November and December, and it was because of a variety of factors.

Ms. Shaw

"But mainly," said Dr. Ramsey, "the state's economy slowed because of declining manufacturing employment which experienced strong growth from 1994 until last fall."

Dr. Ramsey

The share of manufacturing jobs in Kentucky is much greater than the nation as a whole. Manufacturing jobs are our best-paying jobs, and so when we lose manufacturing jobs, it has a profound impact on our economy.

Ms. Shaw

The state revenue shortfall for the 2001-2002 fiscal year has amounted to \$533 million. prompting two rounds of budget cuts.

Dr. Ramsey

We made cuts earlier this year of \$326 million, and now we're in the process of cutting another \$206 million. When we make those cuts, we will be in balance. Our revenues and expenditures will be matched, but we will have dramatically cut state programs, and we've tried to do it in a way that hasn't caused a lot of pain, and a lot of impact on program delivery. That's meant that we've used a lot of one-time monies, we've gone to our budget reserve trust fund, and we've captured vacancies.

Ms. Shaw

The state generates revenue primarily by individual income taxes and the sales tax. Those two taxes combined make up about 70 percent of the state's general fund. The general fund finances most of the operations of state government, save highway construction and maintenance. Recommendations for modernizing Kentucky's tax structure include broadening the sales tax base to services, and collecting sales tax on remote sales in catalog and Internet sales, which could generate an additional \$2.5 billion.

Dr. Ramsey

Our sales tax was enacted at a very different time in Kentucky's history, a time when you and I purchased a lot of tangible goods, and our sales tax applied to tangible goods. It does not apply to services for equity reasons, fairness reasons. We've exempted food, prescription drugs, and utilities from the sales tax. And then, you and I as consumers have changed the way we operate. Today it's very common for us to pick up a catalog and order things and it is very common for us to get on the Internet, and those purchases are not subject to the Kentucky sales tax.

Ms. Shaw

Dr. Ramsey says there's wide agreement that many poor working families are taxed too heavily. And there is a question as to whether businesses should assume more of the tax burden.

Dr. Ramsey

Our biggest concern was that in this new economy that we live in, this new knowledge-based economy, our tax structure seemed to be a little bit out-of-date, and we have a higher tax burden on many of those growth industries, and a lower tax burden on some of the industries that have been very important to Kentucky over time, but are not the growth industries as we move forward.

Ms. Shaw

So can Kentucky achieve the ideal tax system and what would it look like?

Dr. Ramsey

It's impossible to ever achieve the optimal, and I think what you want to try to do from a public policy perspective is make improvements. And one of the problems in trying to deal with the optimal is that we are often trying to accomplish multiple goals: fairness, simplicity, providing for revenue growth, and making sure that our tax system is competitive and lets us grow.

End of video

Mr. Goodman

So, panel, I anoint you tax experts for the remaining time, Merlins of modernization. As a former state representative, Joe Clark of Danville said, "Don't tax you, don't tax me," you can finish it, Bill Lear?

Mr. Lear

"... tax the man behind that tree."

Mr. Goodman

Exactly. And I think someone also added, maybe it was Representative Clark, tax reform is when my taxes get cut. Let me ask in the time remaining—there has been a lot of dialogue, a lot of conversation—what is to be done? Tell me what your suggestions are. You are the tax experts now for the remaining few minutes that we have. What is to be done, Bill Lear?

Mr. Lear

I think that there has to be a sense of urgency in the public generally, and in 139 people. That's what it takes, one Governor and 138 legislators, and that's not a very big group. But it's an awfully difficult one to move when the "t" word is in the room. I was talking to Senator Richie Sanders before the program, and asked him, "When would you think is a good time?" When it is a tough economic time it is the wrong time to talk about messing with taxes. Yet when it is a good economic time, nobody worried about it. So when do you do it? You've just got to sit down and do it. I was thinking before, we may not ever get tax code reform until somebody as innovative as Bert Combs was comes up and files a lawsuit over tax equity that has the result that the lawsuit did that gave rise to KERA. That may be the only way we ever get it done.

Mr. Goodman

Steven Reed, what should be the goals of tax modernization?

Mr. Reed

I hate to overuse the word "smart," but I keep hearing the words smart growth, smart seat belts, smart braking systems, whatever—we have to have smart taxation. I think that government is doing us a disservice if our goal is to simply say, "How can we survey the landscape and get more money out of people and how can we bring in more?" The appetite to spend will always be there and it's going to continue to grow. I think that it is the responsibility of government to look at our tax system, look at our spending, and say, "How can we spend prudently and invest wisely?" I, as a citizen who pays taxes, would much rather pay less taxes. All of us would. On the other hand, if I see where the government is investing wisely and spending prudently, I'll have much less resistance to higher taxes. And I think it's incumbent upon Kentucky to not get in a room in Frankfort and just sit around and say, "How can we get more money, whether it's Internet, catalog sales, or services?" I think it's incumbent upon the people and the representatives and the government to look around this country and to look at all of the other states. Kentucky can't determine the success of the national economy, and I understand that—we're all hurting. But some states are faring better than others. Why are they faring better? What can we do to fare better the next time this comes? What can we do to fare better, to get us out of this?

Mr. Goodman

Talk to me a little bit about that, panel. Where is the balance between immediate need and long-term?

Mr. Baker

Oh, I was just thinking, I've gone through 10 budget sessions during the time I was in the General Assembly, and with one or two exceptions, I could never remember a time when we were flush with a lot of money. Every time the demands and expectations of the people far exceeded whatever the available resources were, revenue at that time.

What we had to do and make a priority in doing it, is, as he says, spend wisely. And the people need to feel that what we're spending on is something that's really important. Then, if they have to ante up a little more, they'll be willing to do it. But if they feel we're wasting the money or we're spending it indiscriminately, they'll never support additional revenue for things that really are important.

Mr. Goodman

Mayor Cunningham, I see some nods in the affirmative and then I see negatives. Where do you fit in this scenario?

Mayor Cunningham

I was just thinking that, as elected officials, we should be good stewards of the money that we are put in charge of, so to speak, and in following what a couple of these gentlemen have said, it is very important that as elected officials, that we do spend the money wisely that has been collected by our government entity, whether it be a local government or a state government. And, unfortunately, sometimes elected officials don't make good choices, based on different reasons. If they make a hard decision to either make an increase in a fee or to cut a service, then that doesn't make them very electable and that's not usually very popular. But it's my opinion that if we're going to be good stewards of our resources, we can't think about whether or not we're going to be re-elected. We have to think about what's the best thing to do for this situation, for these people.

Mr. Lear

And realistically, Bill, if we wait for the public to think the government isn't spending all the money wisely before we do tax reform, we can just forget it.

Mr. Duncan

I think Governor Patton has a real opportunity here to be a leader and to do something for the next person that serves as Governor. I think he'd have to separate the continuation budget because we are at war, we are in recession. We are going to have to sacrifice from the long-term. And I think he can take a page out of the federal play book because they look at the out years. I think that tax reform in Kentucky has got to bring the players to the table, including the interest groups and look at the out years, because now is the time that people are concerned about it. When we get back to the seven good years, we'll forget about it again.

Mr. Goodman

Of course, Governor Patton may sign a bill or veto a bill, or it might stay on his desk, but he's not going to pass the legislation. Mr. Duncan, is there a will there? Are you suggesting that it needs to be there when we start the session in January?

Mr. Duncan

I think we've got a session in January where we're going to have the rawest political form of politics that ever occurs, in redistricting. We've got to get that out of the way, and then go through the budget cycle issues now. But we've got to look beyond that. If he wants to leave the legacy, this is his opportunity, with a special session, to come up with a budget process, bringing the players together, recognizing the fundamental changes that have happened not only politically but economically in Kentucky, and this could be the legacy of his administration.

Mr. Goodman

Judge Whitaker, University of Kentucky economist Bill Hoyt has written that "taxes are most efficient when the base is broad, the exemptions are few, and the rates are low." In your mind, are we anywhere close to that, and is that one of the goals or one of the possibilities that might be on the table?

Judge Whitaker

I think one example, Bill, would be that, in looking at revenues for counties and again using occupational taxes, predominantly as it affects businesses, catalog sales, and the Internet, there are nearly 154, when we looked at the 163 ways of checking that tax. So if you were a business locating in Kentucky, to generate jobs and growth, picking the right place to locate and then filing your state tax return or local return is very difficult. There are so many impediments that local government has on the very essence of our tax structure. So as the state moves towards tax reform, unless that also is inclusive of local tax reform within the same discussion, again we're going to have some piecemeal legislation. We will still have responsibility for solid waste and jails that are not adequately addressed by the General Assembly, or by the locals, but yet local officials step up. So our goal is keeping taxes low. You know, my priority has been, as judge of McLean County, public safety—saving lives, rescue equipment, fire trucks—because that's the thing that government can do. But, beyond that, I think that we can start by being efficient. E-governance is a great opportunity for local officials. We can use the technology Kentucky has developed and

inherited, and proven itself as a leader, and let cities and counties move into e-governance and online permitting and interacting with local officials. So those are the ways we can be efficient.

Mr. Goodman

There may be some thoughts, some comments, and questions that the audience might have for you today. We'll ask them to make their way to the microphone. But in the time that it takes them to work their way up here through this large crowd, let's talk a few minutes about solutions and suggestions. Some of you may stand for election here, pretty soon, and you are interested in serving again. Some of you will go back to your law practice and wait for some of this to come in the door, maybe, Bill Lear. But let's talk about what are your solutions. What do you want to throw out on the table that the legislators that you've heard from, the Governor, and the legislature which begins on January 8th can seriously look at? What should they take a look at? Mike Duncan, you mentioned a couple of things already.

Mr. Duncan

I think Bill did a good job of giving the history, and I think you've got to start with the history. In Kentucky, at the turn of the century, property and real estate tax was the big thing and it's still very important and has to be a mix of the component. And whether we need HB 44 on that or not is an issue that we have to consider. Then we go to an income tax, and we have to look at the amount of money that we raise from individuals and which individuals. Maybe there are some individuals that shouldn't be included in that. Is the corporate income tax doing what we want it to do? And finally, is the sales tax doing what we want it to do? Are we including what should be included? Those are the pillars that we have to look at. Then we add other things, from the severance tax to the lottery, and something that's not been mentioned that should be on the table is the effect of gambling and the "sin taxes" in Kentucky.

Mr. Goodman

Bill Lear?

Mr. Lear

I think what Mike says is exactly right. The work has been done. Our group looked at about everything the current one is. There are some common themes. You heard Jim Ramsey talk about simplicity and fairness and those things run through, and there's only a certain list of things that you can look at, and they're out there. You just have to make some hard decisions. But I'll give you a great example. Jim Ramsey said two things that are in direct contrast. On the one hand, he said, "We have lost money in state government because we've lost jobs." And on the other, almost the next thing out of his mouth, "We've got to look at putting more taxes on business." Those two are not consistent because we're in a competitive environment for business. If all you do is increase taxes on business, then you're going to dampen Kentucky's competitive advantage to attract more businesses and grow more jobs.

Mr. Goodman

All right, here is a participant from the audience. Give us your name, please.

QUESTIONS, ANSWERS, AND COMMENTS

Questioner

Hi, Bill, my name is Van Needham, and I'm from Fort Thomas, Kentucky. I have a follow-up question on the notion of sales tax on Internet exchanges. We heard this morning that the tax policy task force's own consultant has told it that the dominant number of Internet exchanges actually involve business-to-business transactions. So my question is, as a matter of public policy, do you err on the side of exempting those transactions from the collection of sales tax for the very reason that it might have this perverse effect of depressing the economic environment or do you say no, as a matter of fairness, we do need to collect sales tax on those exchanges because of the tremendous revenue we're losing otherwise?

Mr. Goodman

Who wants to take a shot at that one?

Mr. Lear

I would be glad to and I'd like go back to what I said a moment ago. The biggest problem with our sales tax is all the exemptions. If you eliminated all of the exemptions, the rate would be lower for everybody, and you could still get more money, and that includes a lot of business exemptions, as well as the better-known ones that were

mentioned a moment ago. To me, that would be the first place I would look. There are a billion and a half dollars worth of sales tax exemptions, maybe more than that. Those dollars are probably old. That's a lot of money.

Mr. Goodman

Another response from somebody, anyone want to answer? We have another question or comment?

Questioner

Hello, I'm Julie Brackett from Louisville. You've probably seen in the news that a week ago voters in Washington voted to increase their cigarette excise tax by 60 cents, bringing them to \$1.42 per pack, the highest in the country. On the opposite end of the spectrum, Kentucky's excise tax on cigarettes is 3 cents. It has been at that level since 1970, and as we talk about tax modernization and about the importance of children and the future of Kentucky, obviously tobacco is a critical issue in Kentucky in many ways. But it's also a health issue. Can you comment on raising the cigarette excise tax, what you think of that as a way to not only protect the children of our Commonwealth, but also generate much-needed revenue?

Mr. Goodman

Anne Joseph?

Ms. Joseph

Discussion about that tax has always been considered one of the holy grails of politics. But I think again the environment has changed. And I don't know if we're ready to go to Washington with that, but I really sense that there is opportunity for that to be on the table, too. In 1995, when the tax commission did its work, it was not on the table. I think today, there is probably opportunity for discussion. I think it's going to take us a while to really get to a place where we make a decision to move up. Maybe I'll be surprised. I hope so. But I'd like to hear from my colleagues as well.

Mr. Goodman

Walter Baker, what about it? You've been in the trenches there.

Mr. Baker

Back when I was in the General Assembly, a penny of tax on tobacco sales was \$5 million or \$6 million. Is that right? So you know, if you had, say, a 10 cent increase, that's an extra \$50 million or \$60 million annually, and we would still be one of the lowest states in the nation. So that's something that those of you who are in the General Assembly... *(laughter)* I went there in 1968, and I got gray-headed overnight.

Ms. Joseph

We have talked about the Governor, and we have talked about the members of the General Assembly, I mean critical folks. The members of the General Assembly have to vote, and the Governor has to sign the bill, but, you know, we, as members of the public, have to really play an important role. We are partners in this. They need to know where the public is on these issues, and if these are important issues to us, they need to hear about that. We need to be very clear that, when we talk about these questions—cigarette tax and others as well—that we don't just get back to talking about spending or how much we want to tax, but what are these taxes, what is this spending for? We want quality services, we want a premier education program, and we want a quality of life in our community that is nurturing and supportive. We want a community that welcomes businesses and that businesses will come in when we have this quality of life. We need to be very clear about our expectations. We can't have these wants on the one hand and yet not want to look at spending policies that will satisfy these wants. So we have a responsibility. It's not just the folks over there. It is all of us together.

Mr. Reed

Yes, I think it is important to make sure that we convey the sincerity, if it is that, to the public, that when we talk of tax modernization, it is not just a buzz word or a fancy word for tax increase or tax reform. Many people hear that and they say, okay, there goes the government again, looking for ways to bring in more money. And you have the skepticism and the cynicism immediately. I think it's important for government and for our officials to make it clear to the public that we are looking for smart taxation, and there will be some changes. Everything must be on the table. But I think that when it all shakes out, we must be able to leave the public with an understanding that is clear, that once this taxation is in place, it will be the smartest, most effective tax system in the country, and here's what it will provide and what we're going to spend. Here is how we're going to spend and invest it, so that, when history looks at Kentucky 20 years from now, at this monumental moment, we don't have the state legislators and the Governor running together to say, "Historians are about to record what we've done, let's hurry up and do

something.” What we will record will not be what we do 20 years from now; it will be what we do today. Therefore, it’s important that we not be afraid to have modern taxation, smart taxation, tax reform. We must look it in the eye, be fair with it, be sincere with it, but we have to be smart with it. And I tell you again, we must do more than just devise ways to bring in more. We must devise some sincere and effective ways to control the amount we spend to make sure it’s more effective, and that it’s wiser.

Mr. Lear

Could I tag on to that, just quickly? This relates to the tobacco tax. We also have to have some vision. Let me explain what I mean by that. The whole time I was in the General Assembly, you couldn’t even talk about the tobacco tax because the theory was you would hurt the tobacco farmers if you increased it, even the nominal amount that Walter mentioned. The truth is, it had nothing to do with the tobacco farmer because it is imposed upon the smoker, and as we’ve seen, the tobacco farmer has been killed—even though Kentucky’s tobacco tax has been low. If we had adopted a tobacco tax that was even below the national average 20 years ago and earmarked those funds to help the farmers and to help the farmer make a transition to a new economy, we would have had a pile of money that would have dwarfed the tobacco settlement monies, and they’d be well ahead of where they are today. We didn’t do that and we found out that it really didn’t help them by not doing it.

Mr. Goodman

Did somebody else have something?

Judge Whitaker

I just left the KACo conference and am going back this evening. The theme this year is changing attitudes. And over the course that I have served within the last year, probably the two most controversial things, the other second and third holy grail, other than tax reform tax policy, is smart growth. Some call it planning and zoning, but in each of those, as we move into how to develop, how do we grow Kentucky and do it smart? How do we do it wisely, efficiently, and cost effectively where there’s infrastructure and homes in place, and do in field and all the things in the nice report that was just released in Shakertown? And as local officials now, and I hope with the Governor and the General Assembly, our job now becomes reselling, revisiting, and revisioning the reasons why we need elements such as smart growth or well developed and well thought-out communities.

Mr. Goodman

Let’s talk just a minute about efficiency in state government. I’m not sure, forgive me if we’ve mentioned that, but is it a given in state government that we need to be more efficient, maybe possibly provide more services for less money? One state legislator told me last week that the goal of every legislator, every General Assembly, should be to cut spending and the budget. What’s your thinking about that, Mike?

Mr. Duncan

There is no question that nationally people think that government spends too much money and they think that government is inefficient. I think in Kentucky we have some examples and reasons to think that that’s true. Look at this recent bribery case over painting bridges. Now, that’s a very basic local service and we need to do something about that. We give the Governor a great deal of power in this state with personal service contracts, without a lot of the accountability. We need to do something about that. When we build this confidence in government and the national polls show that, people don’t, won’t care if they pay more when they know what they’re getting. Steven’s made an excellent case today for the Republican philosophy. *(laughter)*

Mr. Goodman

Should citizens in the state expect fewer services for the dollar?

Mr. Duncan

More efficient services? There are ways of delivering services, licensing, using technology that we have now, to make government more available and more efficient. We’re operating a lot of our local and state governments in the 1950s and ’60s modes. We’ve got to get out of that. It is like in the banking industry. When I started in banking, you had one employee for every half million dollars in asset. Today, you need about one employee for every 3 to 4 million dollars in assets. We’ve got to do the same kinds of things with government.

Mr. Lear

But the principal service of state government is education. We heard this speech earlier. You can’t say you’re going to cut back services from state government and increase education because that is the service.

Mr. Goodman

Steven Reed.

Mr. Reed

You talk about efficiency. I think often government has a tendency to grow, be it patronage, needy services, or whatever you want to call it. Growth in terms of a business, perhaps, is good. It means more sales, more jobs, more sales to out of state, perhaps out of the country. That, in turn, helps the industry here in Kentucky, which gives us more money for needed services. Growth on the part of government, on the other hand, doesn't necessarily signal the same benefit because it may again be patronage. It may be not only just more patronage, but everybody, as you know in today's world, has to have an assistant or maybe two. Everyone wants a nice office, and as we move into that, that has costs. We have to pay for that. There's no doubt that the government has to be more efficient, more effective, and leaner. That's pretty clear.

Mr. Goodman

A final quick question or comment from Ron Crouch.

Mr. Crouch

Ron Crouch from the Kentucky State Data Center at the University of Louisville. We are a low-wage state, a low-skill state headed into a knowledge economy. Can we increase the tax base by increasing the educational capital of our Kentuckians, or are our citizens going to have to reinvent themselves? And, isn't that a key to major tax reform because it gives us more tax revenue?

Mr. Goodman

Steven, why don't you go on and. . .

Mr. Reed

Without a doubt. It goes back to my initial premise that the government has to be involved in securing and arranging for people's freedom and education. The state of Kentucky has to look around and see what is going on nationally, and see the investment in education that other states have made. And in turn, that's an investment: it yields us something which is cyclical, and it allows us to build and grow and continue to grow.

Mr. Goodman

All right. Final suggestions, advice or wisdom from you. You're going up to the Capitol January 8th. Begin your advice to them as they go into session. Judge Whitaker?

Judge Whitaker

One look back at SB 163. I think we have spent a lot of work there on SB 163. Give local officials the opportunity to work with the legislator and try to address some conflict there and in tax/revenue sharing.

Mr. Goodman

Who else has got an idea? Bill Lear?

Mr. Lear

I would echo what Mike said. Get through this session, and then call a special one and deal with tax code reform at that time.

Mr. Goodman

Walter Baker?

Mr. Baker

Well, don't establish a study commission to look at it. It has been looked at long enough. Just do it! Sit down and make hard decisions, and if you make a fair decision, the people will be with you.

Mr. Goodman

Anne Joseph, in about 15 seconds.

Ms. Joseph

Use those studies that have been done as a basis for decisions to be made, so we don't need new studies, but we need thoughtfulness, and we need deliberate consideration, and then we need to know that we understand what the needs are.

Mr. Goodman

Thank you for sharing your thoughts. Let's all meet there on January 8th, what do you think? Thank you very much.
(*applause*)



**Dr. Paul Cook and
Senator Alice Forgy Kerr,
Kentucky Long-Term
Policy Research Center
Board Members,
discuss the
events of the day.**

**Betsy Nowland Curry
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KY Commission on Women
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